National Bank of Romania

Inflation Report

August 2019

Year XV, No. 57

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NOTES

Some of the data are still provisional and will be updated as appropriate in the subsequent issues.

The source of statistical data used in charts and tables was mentioned only when they were provided by other institutions.

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Foreword

The primary objective of the National Bank of Romania is to ensure and maintain price stability, with monetary policy being implemented under inflation targeting starting August 2005. In this context, active communication of the monetary authority to the public at large plays a key role, and the major tool that the central bank uses to this end is the *Inflation Report*.

Apart from analysing the most recent economic, monetary and financial developments and explaining the rationale and the manner of implementing monetary policy in the previous period, the *Report* includes the National Bank of Romania's quarterly projection on inflation over an eight-quarter horizon, including the associated uncertainties and risks, and a policy assessment built upon the recent and future macroeconomic context from the perspective of the monetary policy decision.

By drafting and publishing the *Inflation Report* on a quarterly basis, in accordance with the frequency of the forecasting cycle, the National Bank of Romania aims to provide all those interested with the opportunity of best comprehending its analytical framework and hence the reasons underlying the monetary policy decisions. Securing a transparent and predictable monetary policy is meant to strengthen monetary policy credibility and thus help achieve an effective anchoring of inflation expectations and lower the costs associated with ensuring and maintaining price stability.

The analysis in the *Inflation Report* is based upon the most recent statistical data available at the date of drafting the *Report*, so that the reference periods of indicators herein may vary.

The *Inflation Report* was approved by the NBR Board in its meeting of 5 August 2019 and the cut-off date for the data underlying the macroeconomic projection was 31 July 2019.

All issues of this publication are available in hard copy, as well as on the NBR website at http://www.bnr.ro.

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Summary

Developments in inflation and its determinants

The annual CPI inflation rate saw a slowdown in 2019 Q2, to 3.84 percent in June. Although it stood 0.2 percentage points below the end-Q1 level and 0.1 percentage points below the forecast in the May 2019 *Inflation Report*, the annual CPI inflation rate continued to overshoot the upper bound of the variation band of the target. Behind the disinflationary traction stood the exogenous components, the fuel price dynamics benefiting from the correction in the oil price in the second part of the quarter, while in the case of tobacco products, the favourable contribution was associated with the earlier implementation of the excise duty hike (in 2018 the excise duty on tobacco products was increased on 1 April). However, the annual adjusted CORE2 inflation rate posted a pronounced upward trend, rising by 0.6 percentage points in Q2 versus end-Q1 to 3.3 percent. The average annual inflation measures recorded mixed developments during Q2: the average annual CPI inflation rate calculated based on the national methodology followed a downward path in April-June, coming in at 4.1 percent at end-Q2, while the average annual HICP inflation rate remained at 4 percent in June, with the differential versus the EU average staying high (above 2 percentage points).

During 2019 Q2, the annual adjusted CORE2 inflation rate continued to follow the visibly upward trend seen in early 2019, owing primarily to price developments in the components of services and food items in the period under review. Thus, the prices of telephony and television services rose amid the legislative changes regarding the hike in taxes applicable to telecommunication companies. Equally important was the evolution of processed food prices reflecting supply-side shocks on the pork meat segment, in this case the inflationary potential remaining relevant for the coming periods too. At the same time, core inflation continued to persistently capture pressures from companies' labour costs amid the further high degree of labour market tightness, as well as from excess consumer demand. In parallel, although the dynamics of economic agents' inflation expectations stagnated or slightly decreased during Q2, the levels recorded continue to be elevated, confirming the latent inflationary pressures in the economy.

In 2019 Q1, the annual growth rate of unit labour costs economy-wide moderated to 6.1 percent (down 4.5 percentage points from the previous quarter), due to the slowdown in the annual dynamics of the compensation per employee and to the recovery of labour productivity. By contrast, January through May 2019, the annual rate of change of unit wage costs in industry rose to 10.5 percent (up 4.7 percentage points from 2018 Q4[1]), thus reaching an outstanding level for the post-crisis period. Although the leap is mainly attributed to the faster increase in wages, the erosion of

1 Excluding the effect of the fiscal changes implemented at the beginning of 2018.

the annual growth rate of labour productivity in industry also played an important part. Nevertheless, there are industries which saw positive developments (crude oil processing, manufacture of chemicals, manufacture of wood), whereas, in the auto industry, the annual dynamics of wage costs continue to stand below those of labour productivity.

The widening of the gap between the two components of unit wage costs can jeopardise the competitiveness of Romanian exports on international markets and lead to the pick-up in prices paid by domestic consumers.

Monetary policy since the release of the previous *Inflation Report*

In its meeting of 15 May 2019, the NBR Board decided to keep the monetary policy rate at 2.50 percent per annum and leave unchanged the deposit facility rate and the lending facility rate at 1.50 percent and 3.50 percent per annum respectively. The annual inflation rate went up to 4.11 percent in April, above the variation band of the target and above the forecast. The upward movement was due to the hike in vegetable and fruit prices, as well as in fuel and tobacco product prices, with core inflation making also a significant contribution thereto. The annual adjusted CORE2 inflation rate climbed from 2.7 percent in March to 3 percent in April, on account of rising demand-pull and wage cost-push inflationary pressures, as well as of higher prices for telecommunications services, in the context of the new tax on companies in this sector. The latest forecast underlined the outlook for the annual inflation rate to remain above the variation band of the target for the next three quarters, before returning and staying in the upper half of the band until the end of the forecast horizon.

The uncertainties and risks associated with the inflation outlook were further related to the impact of the set of fiscal and budgetary measures implemented this year[2], the fiscal and income policy stance and labour market conditions. The developments in the current account deficit were also a cause for concern. Moreover, the uncertainties surrounding the pace of euro area and global economic growth, the developments in the international oil prices and the monetary policy stances of the ECB and of the Fed, as well as of central banks in the region also remained relevant.

Subsequently, statistical data showed that the annual inflation rate remained relatively flat at 4.1 percent in May (4.11 percent in April), above the variation band of the target and mildly exceeding the forecast, as the slowdown in the annual dynamics of fuel prices and tobacco product prices was fully offset by the step-up in core inflation (to 3.2 percent). Apart from the impact of the new tax levied on telecom companies and of the hike in some international agri-food prices, the advance mirrors strong demand-pull and wage cost-push inflationary pressures, alongside the upward adjustment in short-term inflation expectations. Economic growth data for 2019 Q1 indicated a faster annual growth rate of real GDP to 5 percent from 4.1 percent in

[2] Including the impact of the tax on bank assets and of the new IRCC index on lending and on the monetary policy transmission mechanism.

the previous quarter. On the demand side, final consumption was the main driver of economic expansion, the swifter pace of increase owing, inter alia, to a base effect, ahead of the change in inventories and of gross fixed capital formation, whose dynamics re-entered positive territory. By contrast, net exports had a larger negative contribution to GDP dynamics against the background of a wider negative differential between the growth rates of exports and imports of goods and services. Data for April 2019 showed a faster rise, in annual terms, in both trade deficit and current account deficit compared to those seen in 2019 Q1.

In the NBR Board meeting of 4 July 2019, the latest assessments revealed the prospects for the annual inflation rate to remain above the variation band of the target over the short time horizon, with some small fluctuations, and follow a trajectory in line with the medium-term forecast published in the May 2019 *Inflation Report*. The uncertainty factors identified previously remained relevant. Particularly important were considered the prospective easing of the monetary policy stance by the ECB and the Fed, and the conduct of central banks in the region.

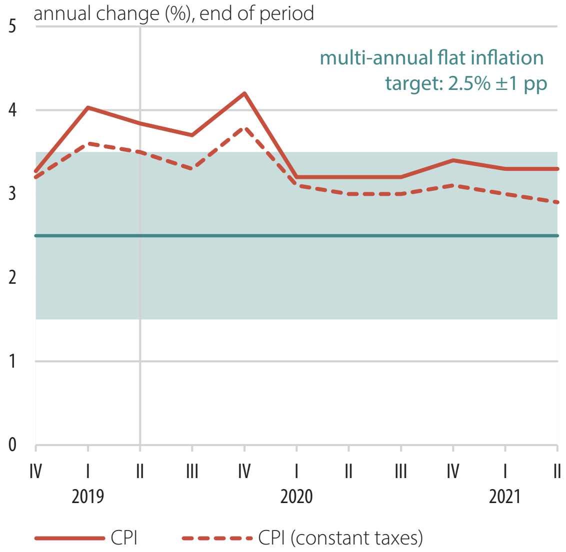
Based on the data available at that time and in the context of the identified risks and uncertainties, the NBR Board decided to keep the monetary policy rate at 2.50 percent per annum, while maintaining strict control over money market liquidity. Moreover, the NBR Board underlined that the balanced macroeconomic policy mix and the implementation of structural reforms designed to foster the growth potential over the long term are of the essence in preserving macroeconomic stability and strengthening the capacity of the Romanian economy to withstand potential adverse developments.

Inflation outlook

According to the baseline scenario, the annual CPI inflation rate will reach 4.2 percent at end-2019 and 3.4 percent at end-2020. Compared to the previous *Inflation Report*, the updated scenario foresees a similar level for this year-end and a marginally upward revision, by 0.1 percentage points, for the next. For the current year, the relatively more favourable developments in the exogenous components of the CPI basket are expected to be offset by a swifter pace of core inflation, while the upward revision of the end-2020 inflation forecast was solely driven by the adjusted CORE2 inflation. Although the cumulated contribution of exogenous components is only marginally revised from that anticipated in the May 2019 *Inflation Report*, subcomponents were more broadly reassessed following the developments recorded earlier this year: lower oil prices in June that impacted fuel prices and July's drop in the price of gas delivered to households, which had a bearing on administered prices. Conversely, the hike in cigarettes prices in July put upward pressure on the aggregate CPI.

The inflation dynamics were still marked by the effects of the recently-adopted legal legislation (Government Emergency Ordinance No. 114/2018, as amended by Government Emergency Ordinance No. 19/2019), even though the magnitude of some adjustments was revised somewhat from the previous round. Specifically, in the case of the annual adjusted CORE2 inflation rate, the pressure exerted by higher

Inflation forecast



Source: NIS, NBR projection

prices of telecommunication services following the additional taxes levied on the turnover of companies in this sub-sector, although it accounted for half of the second-quarter increase in core inflation, witnessed slight downward corrections. Turning to administered prices, the updated scenario incorporated the Romanian Energy Regulatory Authority's decision, effective 1 July, to lower by more than 5 percent the regulated price of natural gas delivered to households. This measure was favoured by the previous decision to cap the selling price of gas for domestic producers at lei 68/MWh.

Data published after the release of the May 2019 *Inflation Report* showed more favourable developments in first-quarter economic activity, amid larger capital accumulation and a renewed step-up in household consumption dynamics, whereas net exports, acting in the opposite direction, increased their negative contribution. Resting on these premises, economic activity is expected to grow this year at a similar annual pace as in 2018, before losing some momentum in 2020. Economic growth composition will continue to reflect the prevalent contribution of household consumption. At the same time, the prospects for the dynamics of gross fixed capital formation to return and remain throughout the reported period at positive values are taking shape, while the contribution of real net exports of goods and services will stay negative, but slightly narrowing during 2020. While the baseline scenario shows an improved outlook for gross fixed capital formation, the projected annual dynamics are foreseen to near the post-crisis average. In addition, the materialisation of the scenario is strictly conditional on the absence of adverse effects over the medium term associated with the recent fiscal measures, on a sustained pace of EU funds absorption, on public investment spending, and on further foreign direct investment inflows, in an external environment marked by elevated uncertainty.

Starting from the latest figures, the baseline scenario envisages the current account deficit to widen further as a share of GDP in 2019, compared to 4.5 percent in 2018, followed by a relative stagnation in 2020. Against this backdrop, the European Commission's scoreboard indicator monitoring the external imbalance in EU Member States[3] is foreseen to overshoot the 4 percent-of-GDP threshold as early as this year. Given the faster build-up of external imbalances in the case of Romania than in its regional peers and the outlook for a slowdown in trading partners' economic activity, this evolution is likely to fuel several vulnerabilities of the Romanian economy, with an impact also on the gradualness and macroeconomic consequences of future adjustments needed to redress these imbalances.

3 Calculated as an average for the past three years. For further details, see the European Commission website, the Section on "Macroeconomic Imbalance Procedure Scoreboard".

The output gap is anticipated to follow a slightly upward path until the beginning of 2020, before flattening out somewhat. Its path reflects the further accommodative real broad monetary conditions (expected to persist only until the first part of next year), an increase in effective external demand (although at a slower pace than in 2018), as well as fiscal policy pro-cyclicality (largely on the back of significant growth in the pension point). The new output gap levels were revised upwards compared to the previous *Inflation Report* over the entire forecast interval. They reflect a more stimulative impact of real broad monetary conditions as well as the revision of the fiscal impulse to higher levels in 2019, yet with persisting effects over the projection horizon. External demand is envisaged to have a relatively more favourable impact compared to the previous round, but only starting in the second half of 2020.

According to the baseline scenario, the annual adjusted CORE2 inflation rate is forecasted to stay on an upward path until the end of 2019, when it is projected to reach 3.9 percent, slowing down thereafter to stand slightly above the upper bound of the variation band of the target (3.6 percent) at the end of 2020. Starting from the level of 3.3 percent in June 2018, inflationary pressures that have been building up within this component will intensify, alongside the rise in excess aggregate demand in the economy and the increase in economic agents' inflation expectations, and amid stronger inflationary pressures from the leu-expressed prices of imported goods starting in mid-2020.

Against this background, the monetary policy stance is configured to ensure and preserve price stability over the medium term in a manner conducive to achieving sustainable economic growth and safeguarding a stable macroeconomic framework.

The balance of risks to the annual inflation rate projection is assessed as being tilted to the upside compared to its path in the baseline scenario, due mainly to domestic factors. Relevant risks continue to be associated with the external environment as well, yet such pressures appear to have a rather disinflationary potential.

Despite the abatement of some risks highlighted in the previous round, fiscal and income policy conduct retains its relevance as a source of risks, but especially of uncertainties over the projection interval. The configuration of these policies could be affected by the multiple elections scheduled for 2019-2020 – with successive rounds of presidential, local and parliamentary elections –, given that both the characteristics of this year's budget execution and the set of measures aimed at raising the pension point (in 2019 and 2020) would most likely require sizeable offsetting measures to ensure compliance with the reference budget ceilings. Such measures are also warranted by the need to compress excess aggregate demand in the economy, a critical step in mitigating the risks of a further increase in the external imbalance and, thus, of sustainably ensuring its financing sources.

The risks associated with labour market developments are highly relevant also in the current round, due to the still elevated level of tightness related to the persistent structural drawbacks, a feature manifest in the region as well, yet potentially more severe for Romania, which reports the lowest labour force participation rate. These tensions may reshape the dynamics of households' real disposable income, on the one hand, and put pressure on firms' costs, also with an impact on the domestic and external competitiveness of some economic sectors, on the other hand.

Turning to the external front, stronger-than-previously-expected risks stem from the global economic slowdown, also amid the lingering trade disputes, especially those between the US and China. Any escalation of these tensions, via the spreading of protectionist measures unilaterally imposed by various countries, can lead to sharper slowdowns in economic activity, with direct and significant consequences on small open economies such as Romania. Still relevant are the risks associated with the ECB's monetary policy stance and, in this context, with the likely stance of central banks in the region, given the different stages of the business cycle their economies are going through. The final configuration of Brexit is still a significant source of uncertainties, despite their seeming abatement after the deadline was deferred to 31 October 2019.

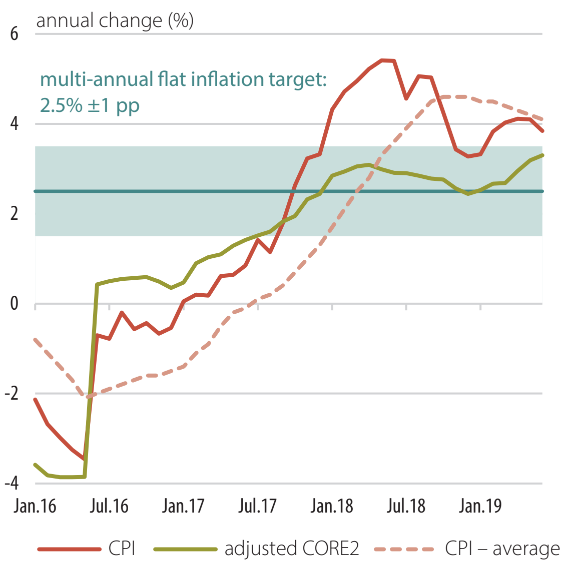
Monetary policy decision

In view of the characteristics of the inflation outlook and the multitude of related uncertainties and risks stemming from both domestic and external sources, also in the context of expectations on/the decisions of the ECB and the Federal Reserve on monetary policy easing, as well as of the probable stance of central banks in the region, the NBR Board decided, in its 5 August 2019 meeting, to keep the monetary policy rate at 2.50 percent, while maintaining strict control over money market liquidity. Moreover, the NBR Board decided to leave unchanged the deposit facility rate at 1.50 percent and the lending (Lombard) facility rate at 3.50 percent. In addition, the NBR Board decided to maintain the existing levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions.

1. Inflation developments

The annual CPI inflation rate declined slightly in 2019 Q2, down to 3.84 percent in June, i.e. 0.19 percentage points below the level recorded at the end of the previous quarter, yet remained above the upper bound of the variation band of the flat target of 2.5 percent ±1 percentage point. This time around, the movement was due to the exogenous components, namely fuel prices, amid the correction of the oil price in the second part of the quarter, and tobacco product prices respectively, following the earlier implementation of the excise duty hike for this year. On the other hand, a series of supply-side and legislative shocks, as well as the fundamentals that continue to characterise the economy (high wage costs, sizeable excess demand) significantly fuelled adjusted CORE2 inflation, which saw a strong acceleration up to 3.3 percent in June, from 2.7 percent at end-Q1 (Chart 1.1).

Chart 1.1. Inflation developments

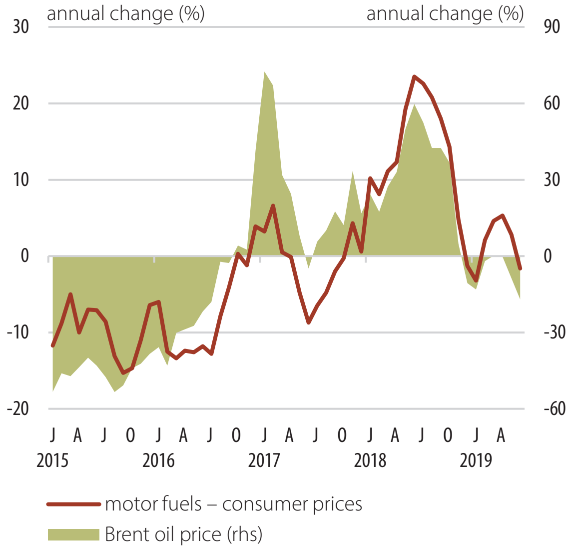


Source: NIS, NBR

2019 Q2 was marked by the high volatility of the oil price per barrel in international markets, on the back of an uncertainty-ridden geopolitical environment. Specifically, amid the escalating conflict in Libya and the new sanctions imposed by the US against Iran, the Brent oil price peaked close to USD 75 per barrel towards the end of April. Afterwards, however, concerns about the global economic slowdown caused by the trade row between the US and China began to prevail, which led the oil price to follow a downward trend, at times below USD 60 per barrel. Under these conditions, but also owing to a favourable base effect associated with the strong rises in the same year-ago period, the annual dynamics of fuel prices declined considerably in May and June, contributing significantly to the disinflation of the aggregate index (Chart 1.2).

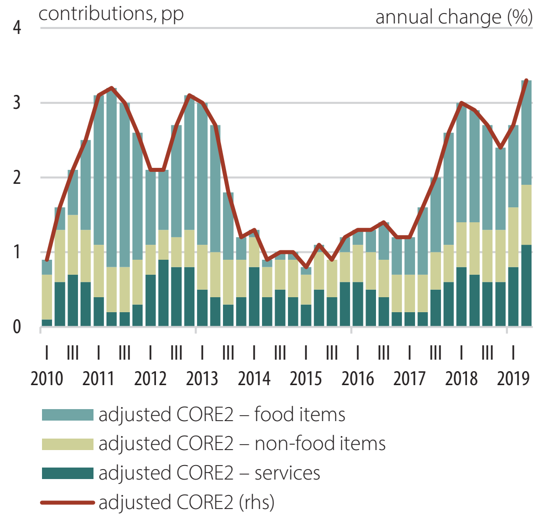
In the case of tobacco products, the deceleration in their annual inflation rate stemmed from the change in the calendar for increasing the excise duty. More precisely, the annual hike in the excise duty, usually implemented every year on 1 April, was applied earlier in 2019, i.e. in the first month of the year. Therefore, the contribution of tobacco product prices to the annual CPI dynamics was lower than at end-2019 Q1, due to the dropping-out from the calculation of the increase in the excise duty implemented in 2018. In addition, administered price inflation also followed a downward path, albeit less steep, amid the slowdown in the annual growth rate of natural gas prices, also due to a statistical effect related to the price increases recorded on this segment in April 2018.

Chart 1.2. Oil and motor fuel prices



Source: NIS, Bloomberg

Chart 1.3. Core inflation components*



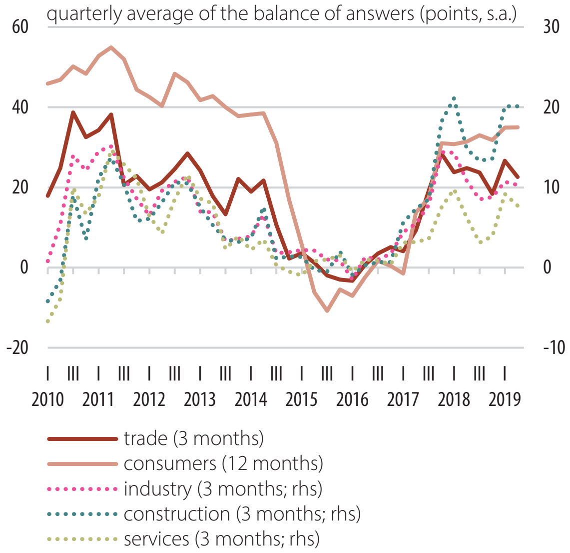
*) excluding the direct effects of VAT rate changes

Source: NIS, NBR calculations and estimates

The adjusted CORE2 inflation rate, which excludes from the consumer basket the items whose prices are beyond the scope of monetary policy, picked up significantly in 2019 Q2, mainly as a result of adverse shocks affecting services and food items (Chart 1.3). In the former's case, the legislative amendments introduced at the end of the previous year on the taxes applicable to telecommunication companies played a decisive part, which translated into price hikes for telephony and television services implemented by all major providers in the market. Overlapping with a slight depreciation of the domestic currency versus the euro, these raised the annual core inflation rate for the services component to a post-2012 high (4.2 percent), accounting for approximately half of the increase in adjusted CORE2 dynamics in 2019 Q2. The movement of processed food prices was equally important, as the supply-side shocks on the pigmeat segment began to pass through into final prices. At the end of the quarter under review, African swine fever outbreaks were reported in 14 countries in Europe and Asia, with numerous cases in China, where almost half the global pig population exists. Domestically, according to the latest data from the Ministry of Agriculture, the outbreak led to approximately 370,000 pigs to be slaughtered, i.e. around 10 percent of the total population on the territory of Romania. However, the hike by around 20 percent of the agricultural price of pigmeat versus the same year-ago period has passed through into the end-user price only to a small extent so far, the inflation of this group reaching 4.5 percent in June, while there are conditions for additional increases in the coming months.

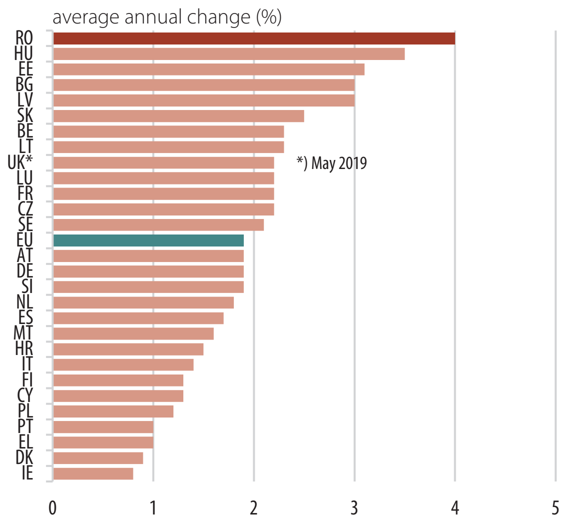
Apart from these specific shocks, the fundamentals painting the economic landscape continue to suggest the build-up of inflationary pressures at the level of adjusted CORE2 inflation. Specifically, April through June, the high degree of labour market tightness fuelled further two-digit annual dynamics of the net average wage economy-wide, for the fifteenth consecutive quarter. Standing systematically above the pace of labour productivity gains, these developments, on the one hand, generate increasingly high unit labour costs for companies and, on the other hand, boost consumer demand, thus easing the pass-through of these costs into the final prices. Consequently, in June, adjusted CORE2 inflation rose to a post-September 2009 high, taking into consideration the values that exclude the first-round effects of VAT rate changes.

Chart 1.4. Expectations on price developments



Source: EC-DG ECFIN

Chart 1.5. Average annual HICP in the EU – June 2019



Source: Eurostat

In 2019 Q2, economic agents in trade, industry and services adjusted downwards their expectations on price developments (the first category posting the highest decrease in the balance of answers), while consumers' and construction managers' expectations remained similar to those in January-March 2019 (Chart 1.4). By contrast, financial analysts anticipate the annual inflation rate for end-2019 to be higher not only than the current one, but also than the level they envisaged at the end of the previous quarter. In addition, the expected inflation rates in the longer term (up to two years) have been recalibrated to slightly greater values compared to those prevailing in the first three months of 2019, albeit remaining inside the variation band.

In 2019 Q2, the average annual CPI inflation rate followed a downward path, both amid the decline in the annual dynamics of consumer prices and due to the dropping-out of the calculation of the values in April-June 2018, when the inflation rate stood at a five-year high. Specifically, the average value based on the national methodology fell slightly to 4.1 percent in June, while the average rate calculated in accordance with the harmonised structure remained at 4 percent, the highest among EU Member States for the eleventh consecutive month, the differential against the EU average still being significant, i.e. over 2 percentage points (Chart 1.5).

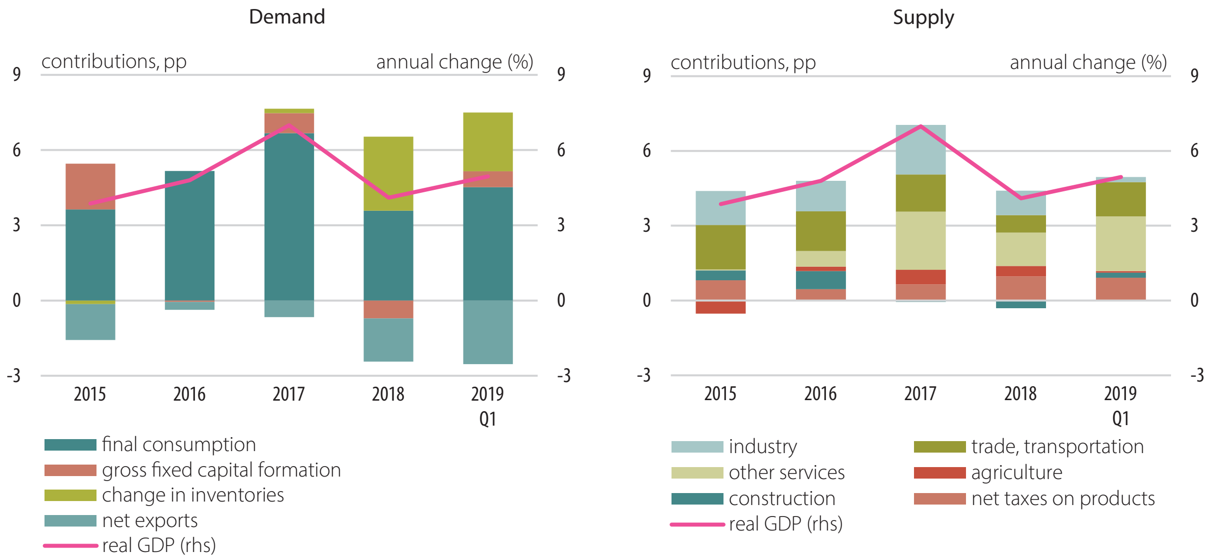
In June 2019, the annual inflation rate stood below the level anticipated in the May 2019 *Inflation Report* by 0.1 percentage points (3.8 percent versus a 3.9 percent forecast). This marginal difference against the forecast was essentially ascribable to larger-than-expected declines in the prices of vegetables and fuels in June 2019. Adjusted CORE2 inflation posted a slightly higher value than the 3.2 percent forecast at the end of 2019 Q2.

2. Economic developments

1. Demand and supply

Year 2019 started with a step-up in the dynamics of real GDP versus 2018 Q4 (up to 5 percent, annual change), on account of the faster advance in domestic absorption at the level of both consumption and investment. The stimulative impact on imports, in parallel with the modest performance of exports, caused however the widening of the external imbalance (Chart 2.1).

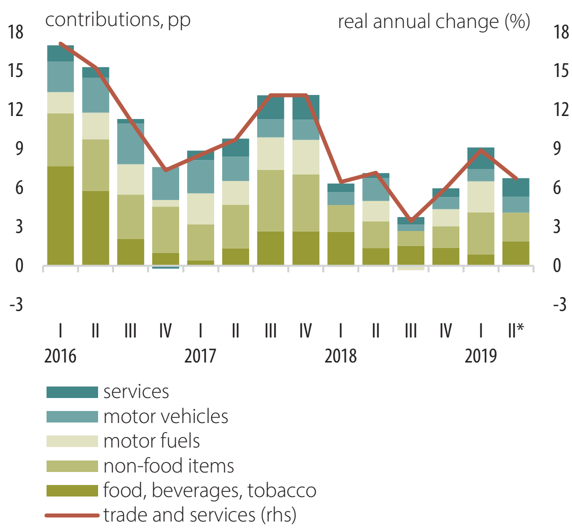
Chart 2.1. Contributions to economic growth



Source: NIS, NBR calculations

Household consumption expanded by 6.2 percent, but this evolution may be ascribed to a statistical effect – while the uncertainty surrounding the transfer of social security contributions payable by employers to the charge of employees resulted in lower consumption at the beginning of 2018, in January-March 2019, the quarterly rate of increase was 1.3 percent, yet slowing down as compared with 2018 Q4. The moderation of consumer demand could be attributed to households' more prudent behaviour, on the back of legislative changes impacting the economic environment (such as GEO No. 114/2018), as shown by the slight erosion of consumer confidence in Q1, despite the significant hikes in real net wage. A similar evolution was also recorded by most retail trade components, except for purchases of furnishings, whose quarterly change picked up considerably, along with the recovery in the real estate sector.

Chart 2.2. Trade



*) Apr.-May

Source: NIS, NBR calculations

Chart 2.3. Outlook for household consumption*

*) seasonally adjusted data

Source: NIS, EC-DG ECFIN

In the period ahead, households' appetite for consumption will probably see a slight slowdown, given that the traction from pay rises is not seen gaining in intensity (although household income will grow at a further swift pace[4] in annual terms), and loan demand will decline somewhat in Q2, amid the moderate tightening of credit standards applied by commercial banks[5]. The slackening of household final consumption is already signalled by the turnover of trade and services, whose annual dynamics decelerated to approximately 7 percent April through May, on account of purchases of non-food items (Chart 2.2). Conversely, sales of food items doubled their growth rate, i.e. up to 6.8 percent, the robust performance of this segment over the past years being expected to continue. This trend is suggested by the investments announced for 2019-2020, which are likely to entail the strengthening of the market share of modern retail chains (about 62 percent in 2018, i.e. 2 percentage points higher than that recorded in the previous year[6]). Consumers' more moderate optimism is also shared by the economic agents in retail trade and services, the EC-DG ECFIN confidence indicator falling in both cases by 2-3 points April through June as against the Q1 average. However, the prospects are favourable for consumers, due mainly to the upbeat expectations on economic situation in the next 12 months (Chart 2.3).

In 2019 Q1, the general government budget execution led to a wider deficit than in the same year-ago period – lei 5.5 billion (or 0.53 percent of GDP) versus lei 4.5 billion (0.47 percent of GDP). At the same time, the narrowing of the deficit against the last quarter of the previous year[7], as suggested by the intra-annual pattern of budget execution, was much lower than that in 2018[8]. It was attributable to the decline in total budget spending[9], largely on the back of capital

4 In April-May 2019, the annual real dynamics of net wages stayed above 10 percent, but decelerated by about 2 percentage points as compared with Q1.

5 As shown in the NBR's May 2019 *Bank Lending Survey*.

6 According to GfK Romania.

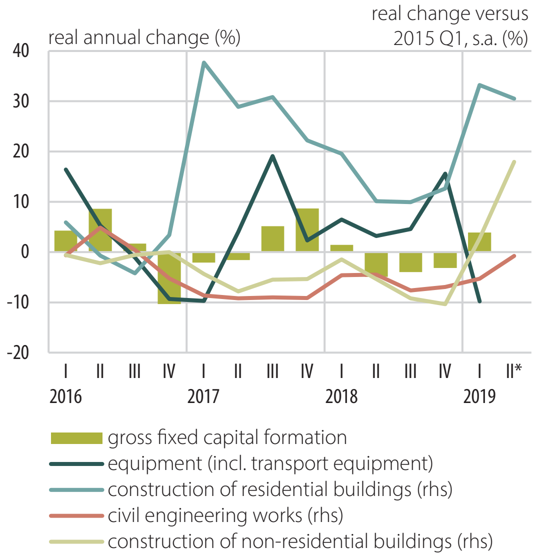
7 In 2018 Q4, the general government budget execution posted a deficit of lei 10.6 billion (or 1.1 percent of GDP), according to the operational data related to budget executions, as published by the MPF on a monthly basis.

8 In 2017 Q4, the budget deficit amounted to lei 17.5 billion (or 2.0 percent of GDP).

9 In annual terms, however, they further posted a sustained real growth rate, similarly to the previous quarter (9.1 percent versus 9.3 percent in 2018 Q4).

expenditure[10] and government spending on goods and services[11], but also amid the growth of social security spending and staff costs[12]. Budget revenues also witnessed a decrease in this period[13], apart from the decline in disbursements from the EU[14], this evolution mainly reflecting the contraction of non-tax revenues[15] and VAT receipts[16]; their impact was only partly offset by the rise in receipts from property taxes and from the tax related to use of goods, to authorisation of the use of goods or to developing activities[17].

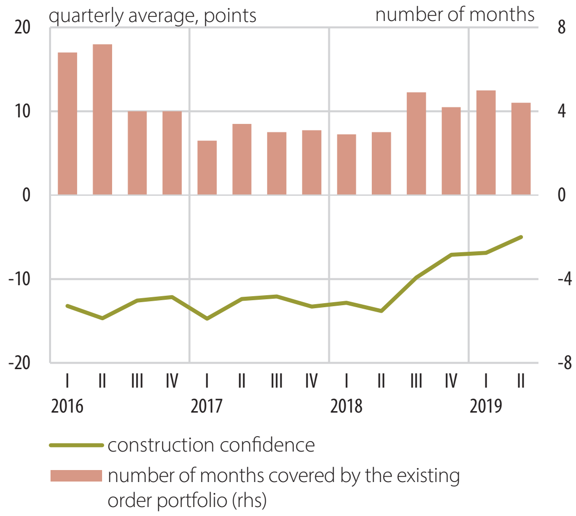
Chart 2.4. Investment



*) Apr.-May

Source: NIS, NBR calculations

Chart 2.5. Outlook for construction*



*) seasonally adjusted data

Source: NIS, EC-DG ECFIN

The pick-up in economic growth was also supported by the rebound in gross fixed capital formation (up 3.9 percent versus -3.2 percent in 2018 Q4, annual changes), amid the expansion in construction works (Chart 2.4). This evolution confirms the recovery signals emerged towards the end of 2018 and may persist in 2019, as indicated by the improvement in the confidence indicator in construction over the first six months (the average of the indicator significantly exceeding that in 2018) and by the advance in the sector's activity by over 30 percent April through May (Chart 2.5). By contrast, equipment purchases saw an adjustment (after the hike in 2018 Q4) and will probably witness a moderate rise in the period ahead.

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10 Also amid a base effect associated with developments in defence expenditure.

11 Spending for projects financed from non-repayable external funds also posted a considerable drop, whose impact on the change in general government budget balance was, however, offset by the decrease in disbursements from the EU.

12 Their real annual growth rate in fact picked up in 2019 Q1, *inter alia* amid the pay rises set forth by the Framework Law on wages for staff paid from public funds and the granting of a stress incentive for the teaching staff in education.

13 A context in which their real annual dynamics contracted substantially, falling yet again below that of total budget expenditure (to 8.5 percent from 21.8 percent in the previous quarter).

14 Their evolution also incorporated a base effect stemming from exceptional disbursements from the EU in 2018 Q4.

15 Most likely also as a result of a base effect associated with the evolution of receipts from dividends from state-owned companies in the previous quarter.

16 However, they continued to record real annual growth, albeit slightly decelerating compared with the previous quarter.

17 Specific to the beginning of the year.

Demand remained robust on the residential segment, due to the swift dynamics of household income during the previous quarters (although the recourse to borrowed funds decreased, as a result of the tightening of lending conditions applied by commercial banks[18]). The supply-side response materialised in the 26.7 percent increase in the volume of construction of dwellings in Q1, a trend that is likely to continue in the period ahead, despite the difficulties still facing the construction companies (higher building materials costs and unit wage costs). As for the workforce, a relative improvement has however been visible, since conditions for granting work permits to non-EU citizens eased and this sector's attractiveness increased for employees after the setting of a sizeable minimum wage floor, the exemption from paying personal income tax and the lowering of social security contributions.

Non-residential construction works also posted a significant increase, i.e. 15.5 percent in Q1, and the market signals also hint at favourable investment prospects for the year as a whole, the relatively small construction area per inhabitant showing that Romania has a higher potential as compared with other regional peers. The floor area of completed buildings is foreseen to increase for all categories of such works, the most optimistic expectations being formulated for logistic and retail facilities. In the latter case, the consumer demand expansion over the past years brought to the fore the insufficient presence of modern trade networks at territorial level, which entailed the step-up in the construction of new facilities. Specifically, the estimates for 2019-2020 show that the floor area of completed buildings will rise markedly as compared with the 2017-2018 period[19].

In the first months of 2019, civil engineering works also recorded a step-up in growth, albeit of a lower magnitude than that of the construction of buildings, which mirrored in the increase by about 19 percent in the volume of public investment (via the recourse to domestic financial resources and the absorption of non-repayable EU funds).

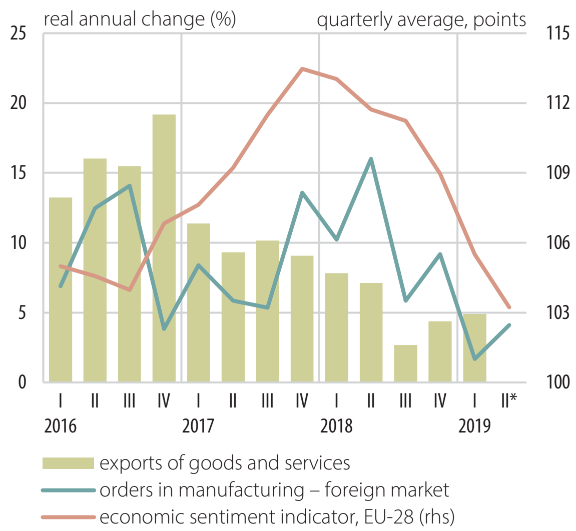
Purchases of equipment (including motor vehicles bought by companies and institutions) decreased by 9.8 percent in annual terms, seeming to undergo a correction after the more than 15 percent rise in 2018 Q4. In the period from October 2018 to March 2019, equipment purchases grew by approximately 3 percent in annual terms, on average, slowing down slightly as compared with the first three quarters of 2018, with higher interest in the expansion or upgrading of production capacities being shown in building materials, the automotive industry and other transport equipment. In the following months, fixed capital investment will probably maintain its moderate pace, as industry seems to have sufficient capital resources to cover demand. This conclusion is suggested by the fact that the capacity utilisation rate in manufacturing stood below the average for the past years in the period from October 2018 to June 2019, whereas new orders are seemingly not particularly high so as to put strains on the production process – the volume of orders saw its annual growth pace decelerating January through May 2019 to less than half the level reported in 2018. Moreover, in the first part of 2019, there was also a slowdown in

18 As shown in the NBR's May 2019 *Bank Lending Survey*.

19 According to *Research & Forecast Report*, Colliers International Romania (2019).

certain financing sources. Specifically, in January-May 2019, foreign direct investment flow in the form of equity and reinvestment of earnings by foreign companies was lower than that recorded in the same year-ago period, while the volume of new long-term loans taken by non-financial corporations in April-May slowed its pace of increase as against the previous quarters, with corporate loan demand being expected to stagnate in 2019 Q2[20].

Chart 2.6. Exports



*) Apr.-May for orders

Source: NIS, EC-DG ECFIN, NBR calculations

Net external demand made a larger negative contribution to economic growth (down to -2.5 percentage points), given that the swifter increase in domestic absorption in Q1 (up to 7.3 percent, annual change) fuelled again the strong expansion in imports of goods and services (9.3 percent in real terms). Furthermore, exports fared significantly worse, thus visibly eroding the contribution of the local industry to real GDP growth (the rise by merely 0.9 percent in annual terms in the gross value added lowered this contribution to 0.2 percentage points). These coordinates will probably remain unchanged in the following months, considering the prospects of persistent pressure from domestic consumer demand, on the one hand, and the subdued expectations on economic activity worldwide, and particularly in the euro area, on the other. In an international environment further marked by uncertainty, also mirrored in the rising volatility of industrial output, the improved evolution in exports[21] and foreign orders to local industrial companies in April-May versus 2019 Q1 must be regarded with caution – in fact, the annual advance recorded by both indicators January through May 2019 is considerably lower than the average performance of 2018 (Chart 2.6).

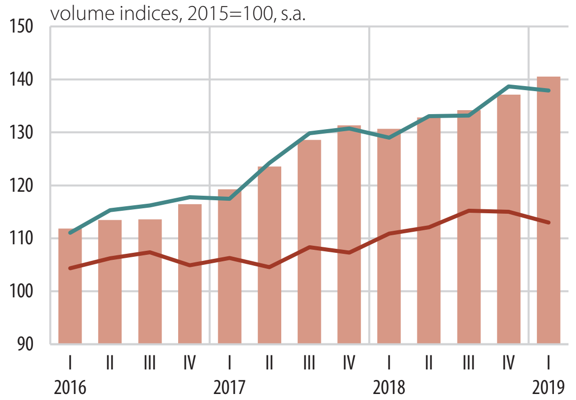
The growth pace of exports of goods remained modest (1.4 percent in real terms), although it was faster than in the previous quarter; its fragility could be ascribed to the drop in sales of motor parts (down by 10.2 percent, annual change), amid the lower demand from major European producers (especially from Germany) and the suspension of exports to Iran as of August 2018, given the escalation of economic warfare between the US and Iran[22]. A downward trend was also visible for exports of electronic components, on the back of lower external demand, as well as for exports of petroleum products and aircraft, two sub-sectors featuring elevated volatility ascribable to scheduled overhauls at the main refineries in the first case and to the significant value and long manufacturing cycle of ordered products. Conversely, exports of capital goods (electric engines and generators, machinery) increased,

[20] As shown in the NBR's May 2019 *Bank Lending Survey*.

[21] Change in terms of value, according to BPM6.

[22] These tensions also had an impact on EU exports to this Asian country, the automotive industry ranking among the most affected sub-sectors.

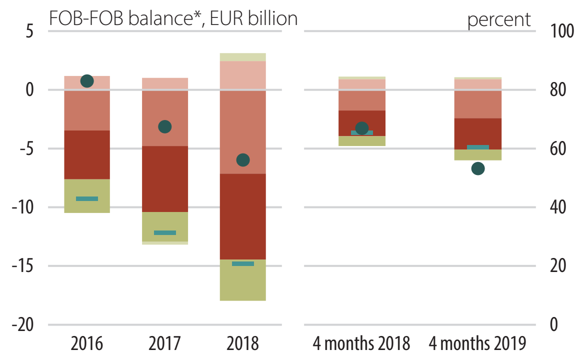
Chart 2.7. Consumer goods: domestic production vs imports*



*) excluding motor vehicles and fuels

Source: NIS, Eurostat, NBR calculations

Chart 2.8. Balance on trade in goods



*) excluding goods produced under processing

Source: Eurostat, NBR, NBR calculations

the same as motor vehicles, which stayed on an uptrend (8.5 percent, change in volume) in spite of the strong base effect due to the launch of two new car models on external markets at the beginning of 2018 (the volume increases in 2018 Q1-Q4 ranged between 29 percent and 41 percent in annual terms).

Imports of goods rose by 6.5 percent in real terms, with consumer goods proving again to be the most dynamic group, which thus made a larger contribution to meeting domestic demand, whereas the local supply of industrial goods for this purpose increased by merely 1 percent in annual terms (Chart 2.7).

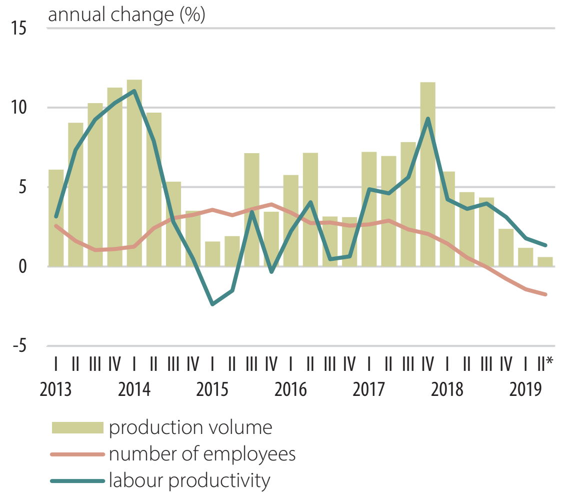
The widening of the imbalance from trade in goods (to EUR 6.4 billion) caused the increase by one third in the current account deficit January through May 2019 as compared with the same year-ago period. The counterweight of net receipts from services to the balance of trade in goods declined further (from 67 percent in January-May 2018 to 53 percent in the same period of 2019), the improved performance of freight transport and ICT sub-sectors being offset by households' increasing preference for international travel and air transport, concurrently with the substantial increase in payments for research and development services (Chart 2.8).

Labour productivity

Due to the robust increase in economic activity in 2019 Q1 and to the relatively stable number of employed persons, labour productivity economy-wide witnessed a rebound (4.8 percent in annual terms, up 1.4 percentage points from the previous quarter), with construction and trade making significant contributions thereto. In the first case, the value added rose simultaneously with the number of employed persons, hinting at the favourable demand conditions that gave a strong boost to building construction works, whereas in the second case, the gain seems to have a structural component (apart from the cyclical influences), due to the renewed expansion of modern trade networks and proximity stores.

Conversely, industry continued to witness adverse developments, as recently noticed, the annual dynamics of manufacturing output volume decelerating again to 1.2 percent in 2019 Q1 and, thus, reaching a six-and-a-half-year low (Chart 2.9). The impact on labour productivity was slightly mitigated by the annual change in

Chart 2.9. Labour productivity in manufacturing

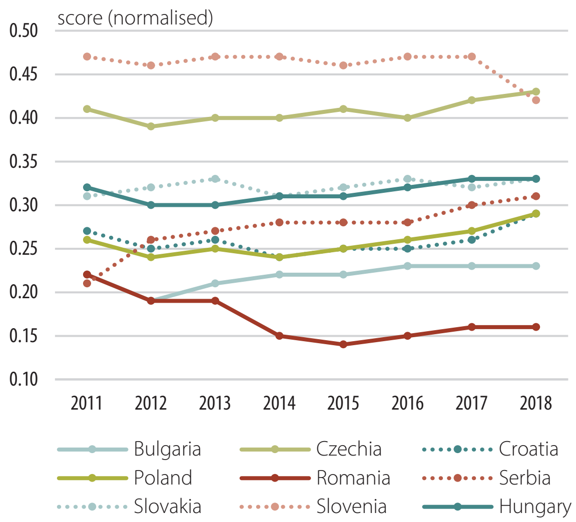


*) Apr.-May

Source: NIS

the number of employees in this sector going deeper into negative territory, as the percentage of industrial managers considering that the shortage of skilled labour limits their business development hit a new post-crisis high. External demand coordinates were decisive for the unfavourable developments in this sector. The fragility of the European industrial sector and the subdued prospects for the period ahead, visible for Romania's main trading partners (Germany, in particular) reflected in the strong weakening in the annual pace of increase of external orders to 1.7 percent in Q1, which was the slowest advance seen over the past 19 quarters. In this context, worth noting are the decelerating dynamics in the activity of the most integrated industries in the global production networks (electrical equipment, the automotive industry) and the decrease in the capacity utilisation rate for all main industrial groupings, except for non-durables. Scepticism prevails among managers in industry, as hinted at by the confidence indicator calculated by the EC-DG ECFIN, which fell into negative territory May through June, mainly on account of worsening expectations on future output.

Chart 2.10. The European innovation scoreboard



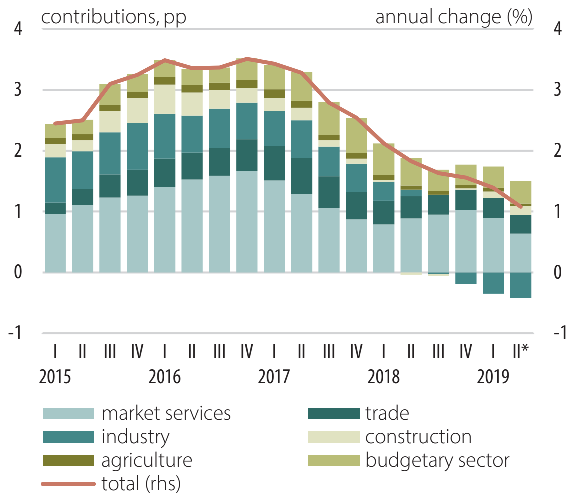
Source: European Commission

The picture painted by persistent factors is not particularly bright either. The downward course in investment in production facilities, captured by the annual drop in equipment purchases, is confirmed by the decline in foreign direct investment in January-May 2019. In addition, the conclusions of *EY Europe Attractiveness Survey* shows that the peak of the investment cycle has passed both domestically and EU-wide. Specifically, after reaching a post-crisis high in 2017, the number of foreign direct investment projects implemented in Europe dropped by 4 percent in 2018 (the first decrease in the past six years), while investors became rather pessimistic, as shown by the strong contraction in the percentage of investors expecting an improvement in the attractiveness of European countries for foreign direct investment in the period ahead. As for Romania, the report estimated the number of FDI projects to go down by 13 percent in 2018 versus the year before, with repercussions on the innovation capacity of the Romanian economy, which was already lower than that of other regional peers and could further affect the structural component of labour productivity (Chart 2.10). In manufacturing, moderately positive signs are nonetheless visible in the building materials sub-sector, under the influence of numerous investment projects for opening and upgrading productive capacities, in the automotive industry, in view of the business expansion of the two car producers, as well as in the other transport equipment, following the substantial external orders to the ship building sub-sector.

Labour market developments[23]

In the period from January to May 2019, the number of employees economy-wide saw its rate of increase re-embark on a downward trend (annual change of 1.4 percent in Q1 and 1.1 percent in April-May, down from 1.6 percent in 2018 H2). The deceleration owed to the private sector, amid the slower hiring pace in market services (more pronounced in administrative and support services and in ICT), as well as the downsizing in industry, especially the automotive industry, most likely in association with investments carried out by leading companies for the automation of production (given the further robust activity in this sub-sector). Conversely, a rebalancing of labour demand-to-supply ratio was recorded in construction, a trend expected to continue in the longer term, considering the tax incentives introduced for this sector (Chart 2.11).

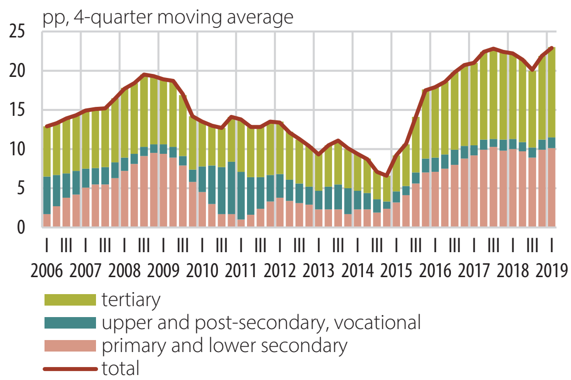
Chart 2.11. Number of employees economy-wide



*) Apr.-May

Source: NIS, NBR calculations

Chart 2.12. Skill mismatch index on the labour market*



*) calculated as the sum of differences in absolute value across each skill group between labour supply (approximated based on the share of the unemployed with a certain level of education in total unemployed) and labour demand (approximated based on the share of the employed with the same level of education in total employment)

Source: Eurostat, NBR calculations

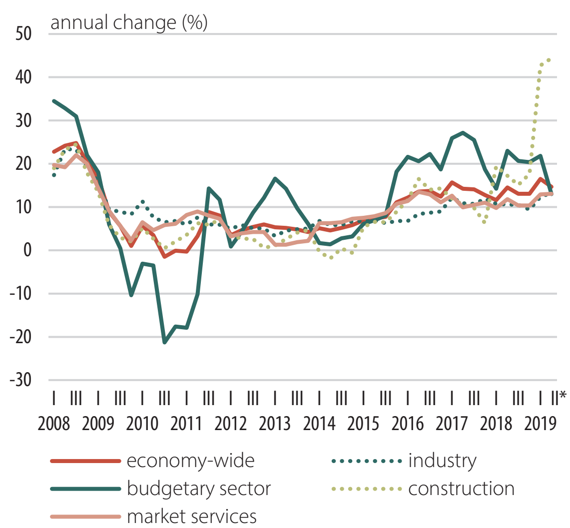
At the same time, the excess labour supply remained very low January through May 2019, with the registered unemployment rate and the ILO unemployment rate coming in at 3.1 percent and 3.9 percent, respectively, at the end of the period (i.e. 0.1-0.2 percentage points below the values recorded at end-2018). Moreover, the job creation process subsided slightly in 2019 Q1, the same as in the previous quarter, yet remained robust. Against this background, labour market conditions tightened in 2019 Q1, with companies further encountering recruitment difficulties – the skill mismatch index reached an all-time high in the first quarter of the year (Chart 2.12). As a result of the difficulty in finding suitably skilled staff, firms have been shifting towards digitisation and automation. According to a study carried out by Cult Market Research between October 2018 and March 2019 among 300 local companies, more than 72 percent of the participating firms cited digitisation as the main option for streamlining activity. At the same time, in order to address supply-side constraints and in view of companies' increased recourse to foreign

23 The analysis is based on seasonally adjusted data; the main sources are NIS, Eurostat and NEA.

personnel[24], the authorities decided to further increase the quota for newly-admitted foreign workers to the Romanian labour market in 2019 (by one third compared to the previous period, up to 20,000 persons).

For the coming period, the two surveys usually referred to (conducted by NIS/EC-DG ECFIN and Manpower) point to strong employment intentions in the trade sector. By contrast, in the remaining sectors, the prospects outlined are rather mixed, the NIS/EC-DG ECFIN Survey suggesting a relative stability and the Manpower survey announcing a further expansion of payrolls, with a sustained hiring pace being expected for manufacturing in particular.

Chart 2.13. Nominal net wage earnings



*) Apr.-May

Source: NIS, NBR calculations

In 2019 Q1, average gross wage earnings grew at a swifter pace, i.e. 15.3 percent in annual terms (compared to 13 percent in 2018 Q4 – net of the effect of fiscal changes as of 1 January 2018), largely on the back of a new rise in the gross minimum wage economy-wide since the beginning of 2019 (by 9 percent to lei 2,080), as well as the setting of a minimum wage of lei 2,350 for highly-skilled personnel and of lei 3,000 for employees in the construction sector. The increase was more substantial for the dynamics of average net wage, i.e. up 3.4 percentage points to 16.5 percent, as the employees in the construction sector were exempted from paying the personal income tax for a 10-year period and social security contributions were reduced for both employees and employers. Subsequently, the annual growth rate of wage earnings (both gross and net) witnessed a slight deceleration April through May, due solely to a base effect in the budgetary sector (Chart 2.13).

2. Import prices and producer prices on the domestic market

Despite a short-lived recovery in main international commodity prices witnessed in the first part of 2019, their levels remained below those recorded a year earlier. Specifically, the annual dynamics of import prices embarked on a downward trajectory, while the growth rate of producer prices on the domestic market followed a less pronounced trend, as domestic factors acted in the opposite direction – supply shortages on the electricity market, high wage costs, and favourable demand conditions.

[24] Also confirmed by the results of an opinion poll conducted by Frames & Train Your Brain, where 62 percent of respondents declared themselves willing to hire foreign workers.

2.1. Import prices

Following the slowdown recorded at end-2018, energy commodity prices went up January through April 2019, amid a cut in oil production driven by the entry into force of a new OPEC+ agreement[25], the situation in Venezuela, the sanctions imposed on Iran, as well as the improved outlook for global oil demand. Oil price neared the USD 75/barrel mark towards end-April before falling to USD 61/barrel in June, as the US-China trade dispute escalated. Looking at the other energy components, the plentiful supply led to a decrease in natural gas price, also exerting a similar influence on the price of coal, one of its substitutes. Despite the short-lived rise in the Brent oil price, the annual growth rate of energy commodity prices stood in negative territory in 2019 H1 (-8.6 percent, according to World Bank data). Moreover, the annual dynamics of metal prices (including mineral products) remained negative in the first part of 2019 (-8.8 percent in January-June), except solely for the price of iron ore. However, the significant increase of the latter did not lead to similar developments in the price of steel, whose market has been characterised by excess supply and unfavourable demand-side prospects (also related to the situation of the automotive industry worldwide). Agri-food commodity prices followed an upward trend in the first two quarters of 2019, resulting in their negative annual rate of change slowing down to -2.8 percent and -1.0 percent, respectively (according to FAO data). This was partly due to the trajectory of pork meat price in the context of weaker supply driven by the African swine fever outbreak affecting particularly producers in Asia (Chart 2.14).

Chart 2.14. International commodity prices

Source: World Bank, FAO, NBR calculations

Movements in international commodity prices also affected import prices. Specifically, January through March 2019, the annual unit value index of imports (UVI)[26] decelerated to 101.0 percent, but the pass-through of this disinflationary effect to domestic prices was offset by the depreciation of the leu against the major currencies. Behind the trajectory of the aggregate UVI stood mainly mineral products (109.2 percent, down 10 percentage points), chemicals (96.3 percent, down 3 percentage points), as well as base metals (100.2 percent, down 3.4 percentage points).

As regards the goods holding a relevant share in the CPI basket, the UVIs of food items stood below 100 percent in the case of animal or vegetal fats and oils and meat products. However, in the latter case a trend reversal is quite likely in the period ahead, given the latest trends on the pork meat market. Conversely, the UVI of vegetal products advanced to 101.8 percent (up 2.3 percentage points), owing to fruits and

[25] Extended in early July for another nine months, to 31 March 2020.

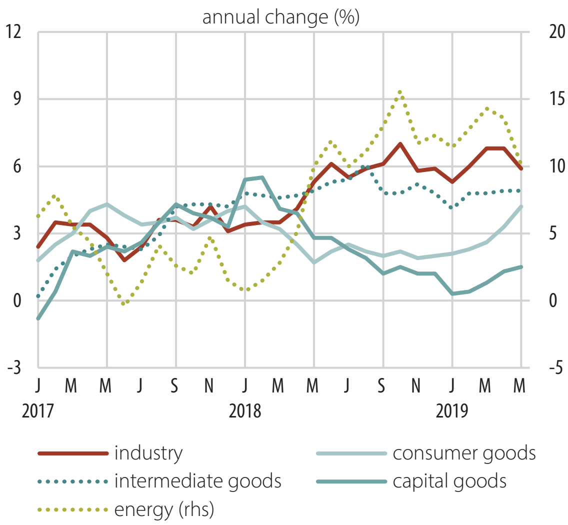
[26] Expressed in EUR.

vegetables, with cereals exerting significantly weaker inflationary pressures. In the case of non-food items, the UVIs of wearing apparel and motorcars came to a near standstill, whereas the UVI of footwear witnessed a decrease.

2.2. Producer prices on the domestic market

The annual dynamics of industrial producer prices on the domestic market followed an upward trend in the first months of 2019, rising from 5.3 percent in January to 6.8 percent in April, before slowing down to 5.9 percent in May, amid mixed developments by sub-sector (Chart 2.15). The growth rate of energy prices remained high (nearly 10 percent in May), while declining gradually during the period under review, concurrently with the progressive correction of the mismatch between electricity demand and supply and the steeper fall in the Brent oil price in annual terms. The annual rate of change of intermediate goods prices stabilised at around 4.8 percent from February to May 2019, the excess demand in the economy paving the way for a sluggish and asymmetrical pass-through of the lower international prices of metals and energy.

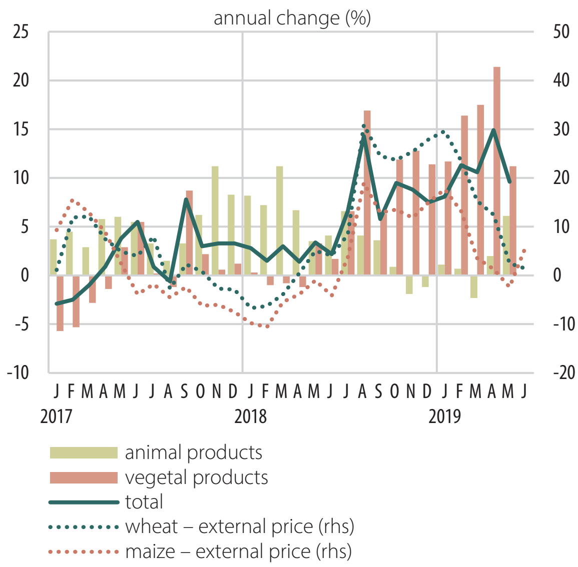
Chart 2.15. Industrial producer prices on the domestic market



Source: Eurostat

By contrast, the annual pace of increase of capital goods prices stepped up to 1.5 percent in May (up 1.2 percentage points from January), in line with the depreciation of the leu against the euro. Historically, a significant correlation is visible between the evolution of producer prices for this category of goods and the exchange rate movements, many such goods having their prices expressed in euro. Moreover, consumer goods prices rose at a faster pace, their annual change picking up to 4.2 percent in May, after one year of stagnation at around 2 percent. Apart from the favourable demand conditions specific to the Romanian economy, a significant contribution to this development had the pressures from rising pork meat prices amid, inter alia, lower supply worldwide.

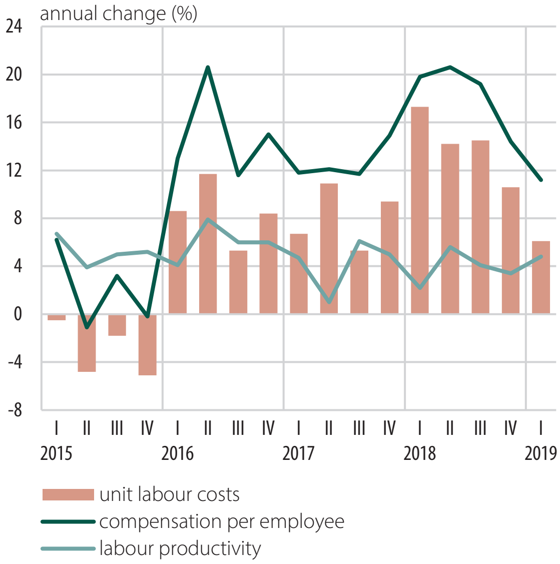
Chart 2.16. Agricultural producer prices



Source: NIS, Bloomberg, NBR calculations

The annual dynamics of agricultural producer prices on the domestic market were further brisk in the first months of 2019, escalating to nearly 15 percent in April, compared to 8 percent in January. The hike was due mainly to vegetal products, given supply shortages for certain types of vegetables (particularly potatoes), also at EU level. However, a correction followed in May, ascribable to the annual dynamics of cereal prices dropping by half, in line with the most recent trends in the external markets. Animal product prices also reported a step-up in their rate of increase, their annual change returning to positive territory, to reach 6.1 percent in May, owing significantly to pork products (Chart 2.16).

Chart 2.17. Unit labour costs



Source: NIS, NBR calculations

Unit labour costs

In 2019 Q1, the annual growth rate of unit labour costs economy-wide moderated to 6.1 percent (down 4.5 percentage points from the previous quarter), due to the slowdown in the annual dynamics of the compensation per employee and to the recovery of labour productivity (Chart 2.17).

By contrast, January through May 2019, the annual rate of change of unit wage costs in industry rose to 10.5 percent (up 4.7 percentage points from 2018 Q4), thus reaching a post-crisis high. Although the leap is mainly attributed to the faster increase in wages (up 3.3 percentage points), the erosion of the annual growth rate of labour productivity in industry also played an important part (down 1.3 percentage points). Nevertheless, there are also industries which saw positive developments, such as crude oil processing (a major contribution having however the refineries' different scheduling of overhauls), chemical industry, and the manufacture of wood. Moreover, in the automotive industry, labour productivity gains continue to cover the annual dynamics of wage costs, a trend persisting as of 2018 Q2.

3. Monetary policy and financial developments

1. Monetary policy

May through July 2019, the NBR kept the monetary policy rate at 2.50 percent and left unchanged the deposit facility rate at 1.50 percent and the lending facility rate at 3.50 percent, while maintaining strict control over money market liquidity. Moreover, the central bank kept the minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions at 8.0 percent. The measures aimed to bring the annual inflation rate back into line with the flat target of 2.5 percent ±1 percentage point and keep it there over the medium term, inter alia via the solid anchoring of inflation expectations over the longer time horizon, while safeguarding financial stability.

In its May meeting, the NBR Board took these decisions in a context where the annual inflation rate had continued to climb above the variation band of the target in March and April[27] and significantly above the forecast[28], while its future path had been revised upwards in the context of the new forecast, especially over the short time horizon; specifically, the annual inflation rate was expected to remain above the variation band of the target until end-2019, before returning to, but also staying in the upper half of the band[29]. The relative worsening of the short-term inflation outlook was mainly attributable to the action of supply-side factors, which, contrary to earlier forecasts, turned inflationary again and was anticipated to remain so in 2019[30], before reacquiring a strong disinflationary nature in the early months of 2020, amid the base effects associated with the recent adverse supply-side shocks.

Inflationary pressures from fundamentals were, however, expected to grow progressively across the forecast horizon, and even slightly more visibly in the longer run than previously projected. Their probable sources were the cyclical position of the economy, the upward adjustment of short-term inflation expectations and the sustained increase in wage costs, as well as the faster dynamics of import prices, inter alia due to the evolution of the leu exchange rate. Against this backdrop[31], the annual adjusted CORE2 inflation rate was expected to climb significantly above the

27 The annual inflation rate picked up to 4.03 percent in March and to 4.11 percent in April from 3.83 percent in February.

28 The medium-term forecast published in the February 2019 *Inflation Report* anticipated a decline in the annual inflation rate to 3.0 percent at the end of 2019 Q1.

29 The annual inflation rate was expected to reach 4.2 percent in December 2019 and 3.4 percent at the end of the projection horizon, compared with the previously forecasted levels of 3.0 percent and 3.1 percent respectively.

30 Owing largely to developments in the prices of vegetables, fruit, eggs, tobacco and fuels, but also to the one-off impact of the new tax on the telecom sector.

31 But also as a result of the impact exerted by the new tax on telephony and radio-TV subscription services.

previously-forecasted values and even above the variation band of the target in the latter part of this year[32], before returning to and remaining marginally below or at the upper bound of the band, slightly higher than previously anticipated.

The positive output gap was expected to widen further over the short time horizon and then remain in the vicinity of the peak of the current business cycle, at levels only slightly lower than indicated in the prior forecast, given that the annual pace of economic growth, albeit decelerating, was expected to remain significantly and then marginally above the potential rate[33]. Furthermore, over the short term, private consumption was seen as the quasi-single driver of economic growth, under the impact of the higher real disposable income – due to wage increases, as well as to the rise in social transfers –, whereas net exports were expected to make a larger negative contribution to GDP dynamics, associated with an increase in the current account deficit.

Significant uncertainties and risks surrounding this forecast stemmed, however, from the future fiscal and income policy stance – which was presumed to become increasingly pro-cyclical across the projection horizon –, but also from the fiscal and budgetary measures implemented in 2019, to which added the uncertainties generated by the new benchmark index for loans to consumers (IRCC), effective 2 May 2019, set at 2.36 percent. Rising uncertainties were also associated with the external environment, amid the slowdown in euro area and global economic growth and the heightened risks to growth outlook induced by the trade row and the Brexit uncertainties. Particularly relevant were the changes in perspective of the Fed's and the ECB's monetary policy stances, as well as the stance of central banks in the region.

According to incoming statistical data and subsequent assessments, the annual inflation rate remained flat at 4.10 percent in May – above the March level and also above the forecast – and its rise in the first two months of Q2 was primarily triggered by the step-up in core inflation[34], whose annual rate climbed, in line with forecasts, from 2.7 percent in March to 3.2 percent in May. Aside from the influences of the new tax levied on telecom companies and of the increase in some international agri-food prices, the evolution indicated heightened demand-pull and wage cost-push inflationary pressures, along with the upward adjustment of short-term inflation expectations. In fact, according to the new data, economic expansion witnessed a stronger-than-anticipated acceleration in 2019 Q1[35], given an unexpected rebound in its quarterly dynamics, implying an advance in excess aggregate demand above forecast. Moreover, household consumption further made a stronger contribution to economic growth, becoming again its main driver[36], whereas net exports had

32 To 3.8 percent in December 2019 against 3.3 percent in the earlier projection.

33 Anticipated to be affected, in turn, by the fiscal and budgetary measures implemented at the beginning of this year, as well as by the previous decline in investment, overlapping the persistent structural deficiencies of the economy.

34 And, to a lesser extent, by the hike in VFE prices; the impact of the two components was partly offset by a slowdown in the annual dynamics of tobacco product prices, fuel price and administered prices.

35 To 5.0 percent from 4.1 percent in 2018 Q4.

36 In the same direction acted the return to positive territory – after three consecutive quarters of decline – of the annual dynamics of gross fixed capital formation, due solely to the upturn in new construction works.

a considerably larger negative contribution[37], in a context where the trade deficit widened significantly faster than in 2018 Q1, also triggering a deepening of the current account deficit in annual terms[38].

At the same time, labour market tensions remained high, inter alia amid the ILO unemployment rate tending to run in the vicinity of its historical low[39] January through April 2019, while the annual growth of average gross nominal wage earnings in the economy stuck to two-digit readings; the annual pace of increase of unit wage costs in industry returned to and remained in the first four months at double-digit levels as well, in the absence of clear productivity gains.

Key money market rates remained significantly above the monetary policy rate in Q2, while the average interest rate on interbank transactions returned slightly below the policy rate May through June, amid the normalisation of liquidity conditions on the market. Furthermore, May 2019 saw the coming into force of the new benchmark index for loans to consumers at 2.36 percent, whose level rose however to 2.63 percent on the first day of Q3. At the same time, the EUR/RON exchange rate witnessed a relatively sharp downward correction towards end-May and at the beginning of June, in tandem with developments in the region, amid signals on the forthcoming easing of the Fed's and the ECB's monetary policy stances, conducive to an increase in the attractiveness of investments on these markets. Moreover, given the higher interest rate differential versus the euro area, towards the end of Q2 the currency pair posted again a slight downtrend, whose potential steepening would have induced risks to inflation developments over the medium term through the adverse impact on the current account, already deteriorating swiftly.

The annual growth rate of credit to the private sector remained relatively steady in April and May, at a level only slightly below the Q1 average. The evolution reflected the annual pace of increase of the domestic currency component continuing to decelerate slowly[40], although sticking to two-digit readings, and the dynamics of the foreign currency component marginally re-entering positive territory in May, for the first time in seven years, solely as a result of developments in the non-financial corporations sector. The share of the leu-denominated component in total private sector credit remained, nevertheless, on an upward path, reaching 66.2 percent. The annual growth rate of broad money slightly stepped up, however, April through May 2019[41], primarily under the impact of the budget execution.

The short-term projection updated in this context showed that the annual inflation rate was seen to remain above the variation band of the target over the short time horizon, with some small fluctuations, and follow a trajectory compatible with that in the medium-term forecast published in the May 2019 *Inflation Report*. The influence of

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37 To a post-2008 Q2 low.

38 Despite the improvement in the primary and secondary income balances in this period.

39 4.0 percent in April versus a historical low of 3.9 percent.

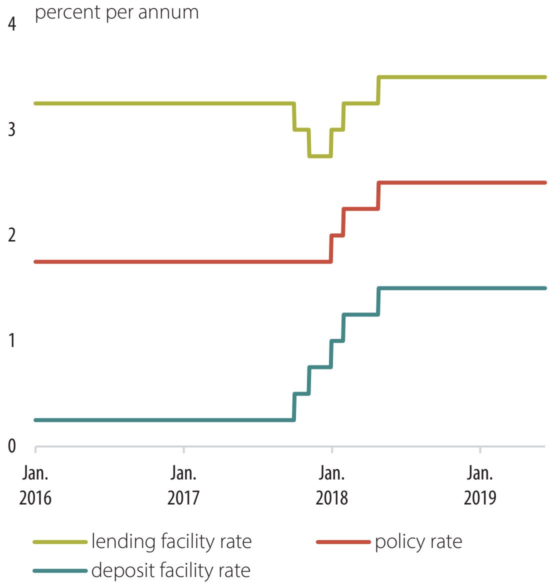
40 Mainly on account of loans to households, whose dynamics nevertheless benefited from the sizeable contribution of new consumer credit, which reached – in terms of monthly volume – a new historical high in May.

41 To an average of 9.5 percent, from 9.3 percent in Q1.

supply-side factors was anticipated to be less inflationary over the short term than in the previous forecast – given the unexpected cut in natural gas price as of July, as well as the relatively slower dynamics of fuel prices –, whereas the action of fundamentals was seen slightly more inflationary, amid the somewhat stronger pressures envisaged to be exerted by aggregate demand, wage costs and short-term inflation expectations. Thus, the probable slowdown in Q2 and Q3 notwithstanding, economic growth was expected to remain relatively more alert, following its step-up above expectations in the first quarter of the year, and with quarterly dynamics anticipated to decline gradually – inter alia amid a less favourable performance of agriculture in Q3 –, which likely implied a further increase in the positive output gap during this period to values slightly higher than those forecasted in May.

However, the assessments also pointed to a rise in the uncertainties and risks associated with the future fiscal and income policy stance – amid the commitment to keep the general government deficit within the ceiling set under the Stability and Growth Pact –, as well as in those related to EU funds absorption. Heightened uncertainties and risks also stemmed from the weakening trend of euro area and global economic growth, given inter alia the higher risks induced by the trade war and by the uncertainties surrounding Brexit. To these added the prospective easing of the monetary policy stance by the ECB and the Fed, and the probable conduct of central banks in the region.

Chart 3.1. NBR rates



Against this background, tailoring monetary conditions with a view to anchoring medium-term inflation expectations and bringing the annual inflation rate back into line with the inflation target, while safeguarding financial stability, warranted the policy rate status-quo and the maintenance of strict control over money market liquidity. Therefore, in its meeting of 4 July 2019, the NBR Board kept unchanged the monetary policy rate at 2.50 percent, the deposit facility rate at 1.50 percent and the lending facility rate at 3.50 percent, while preserving strict control over money market liquidity (Chart 3.1). In addition, the central bank kept in place the current levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions.

2. Financial markets and monetary developments

Longer-term interbank money market rates went up in 2019 Q2 overall and hence saw their positive spread vis-à-vis the monetary policy rate widen, while the average interest rate on interbank transactions[42] fell only marginally versus the previous three months. The EUR/RON exchange rate remained quasi-stable in the first two months of Q2 at the higher readings recorded at the beginning of the year, but afterwards witnessed a relatively sharp downward correction. The annual growth rate of credit to the private sector saw its decline come to a halt, decelerating very slowly April through May 2019 against the 7-year peak seen a quarter earlier, while the dynamics of liquidity across the economy regained some momentum.

2.1. Interest rates

The daily average interbank money market rate[42] climbed and remained in the vicinity of the upper bound of the interest rate corridor in April, before returning and remaining relatively in line with the monetary policy rate, amid the central bank's strict control over liquidity. Hence, its quarterly average[43] stood at 2.68 percent, only marginally below the Q1 reading of 2.71 percent (a five-and-a-half-year high).

Liquidity conditions on the interbank money market tightened considerably in the first month of Q2 – owing to the emergence of a temporary liquidity shortfall[44], accommodated exclusively via the lending facility –, before witnessing a relative normalisation; the latter was due to the re-emergence of a net liquidity surplus in the banking system, following the Treasury's considerable reserve injections[45], and its mopping up by the NBR through 1W deposit-taking operations conducted via fixed-rate tenders with full allotment[46]. Against this backdrop, ON rates on the interbank money market reached and stayed in the vicinity of the lending facility rate during April, before moving down and fluctuating slightly around the policy rate in the following months, witnessing several temporary declines to the lower bound of the interest rate corridor as well, somewhat more persistent in May.

In turn, 3M-12M ROBOR rates saw the upward path they had embarked on in the latter half of March steepen at the onset of Q2, which implicitly led to the widening of their positive spread vis-à-vis the monetary policy rate, inter alia amid the central bank's announcement on maintaining strict control over money market liquidity. In May, they recorded only a slight downward adjustment and solely for the 3M and 6M maturities, while in June they remained practically unchanged, thus ending

[42] The average interest rate on transactions in deposits on the interbank money market (excluding the NBR), weighted by the volume of transactions.

[43] Weighted by the volume of transactions.

[44] Under the contractionary impact of autonomous liquidity factors.

[45] Also in a context where government bonds worth lei 8.8 billion and lei 8.9 billion respectively matured on 29 April and 24 June respectively.

[46] The central bank carried out six such operations during Q2, on 6, 13 and 20 May (worth lei 2.7 billion, lei 2.9 billion and lei 7.6 billion) and on 10, 18 and 24 June (worth lei 0.9 billion, lei 3 billion and lei 2.5 billion) respectively.

Chart 3.2. Policy rate and ROBOR rates

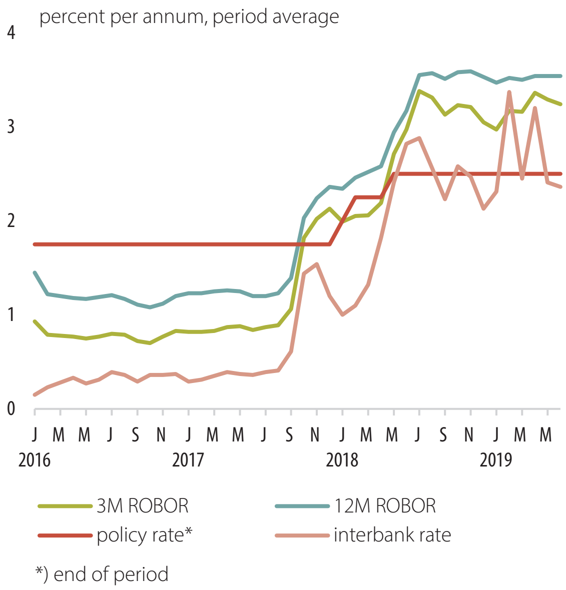
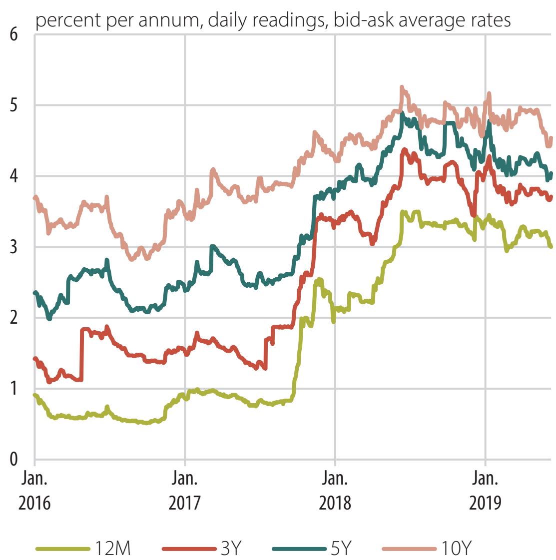


Chart 3.3. Reference rates on the secondary market for government securities



the period at values close to those prevailing in the second half of Q1. Consequently, their quarterly averages rose versus those in 2019 Q1, by 0.19 percentage points for the 3-month maturity (to 3.29 percent, the highest value in the past approximately six years), by 0.08 percentage points (to 3.39 percent) in the case of the 6M rate, and by 0.04 percentage points (to 3.54 percent) for the 12-month maturity (Chart 3.2).

On the government securities market, the evolutions in the first month of Q2 were correlated with money market developments, while the second part of the period under review saw the prevailing effects exerted by the alleviation of concerns over the provisions of GEO No. 114/2018 regarding the financial sector[47] and by the abatement of some political uncertainties, to which added the influences of the keener appetite for investments in the currencies of countries in the region, amid expectations on the forthcoming easing of the ECB's and the Fed's monetary policy stances[48] (Chart 3.3). Thus, after the hike recorded in April[49] and the relative stability manifest for most of May, reference rates on the secondary market[50] embarked on a downward path, which extended until towards end-June, with a markedly steeper slope for 5-10 year maturities, whose levels touched 12-month lows[51]. Under the circumstances, their June averages declined against those recorded in the closing month of Q1 for the 10-year maturity (down 0.19 percentage points, to 4.56 percent) and witnessed a quasi-standstill for the 5-year maturity, but edged up slightly (by up to 0.09 percentage points) across the 6-12 month maturities. Therefore, the yield curve flattened considerably, after the steeper upward slope seen in the previous two quarters.

On the primary market as well, the average accepted rates advanced in April (by up to 0.26 percentage points for 7-year securities), but declined to a larger extent

47 Given the revision of the set-up of the tax on credit institutions' financial assets and of the regulations on private pension funds.

48 In the context of renewed trade tensions and increased investor concerns over the global economic growth outlook.

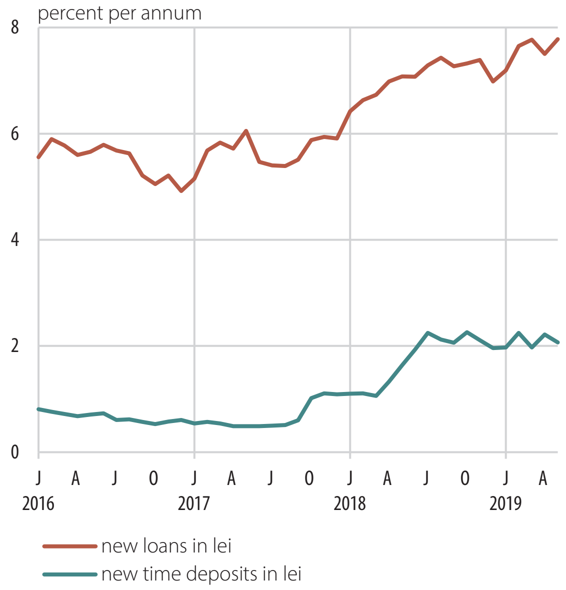
49 Implying the return of reference rates across the 6-12 month and 10-year maturities respectively to the vicinity of the peaks reached towards end-January 2019.

50 Bid-ask average rates.

51 At the end of June, they posted however an upward adjustment, possibly amid the adoption of the pensions law by Parliament.

in June[52] (by up to 0.48 percentage points for the same maturity), thus reverting to similar or even lower levels than those in the closing month of the previous quarter (4.29 percent for the 5-year maturity, 4.24 percent and 4.76 percent for the 7- and 10-year maturities respectively). The revival in May and especially in June in investor appetite for government securities is also illustrated by the increase in the ratio of the amounts of bids submitted to the announced volume to 2.1 and 2.7 respectively (from 1.5 in April) – even amid the further rise in the MPF's supply of government securities –, but also by the upturn in the ratio of the volume of issues to the announced volume (to 120 percent in May and 160 percent in June, from 90 percent in April)[53,54].

Chart 3.4. Bank rates



On a relatively fluctuating path, the average interest rate on non-bank clients' new loans grew at a more sluggish pace March through May 2019 (up 0.12 percentage points to 7.78 percent), while that on non-bank clients' new time deposits even shed 0.18 percentage points to 2.07 percent. The slower advance was more visible in the case of the average lending rate on new business to households, which inched up 0.06 percentage points to 8.66 percent; in addition, its marginal rise was due exclusively to the larger share of new consumer loans (whose volume peaked at a historical high in May), while both the average interest rate on this type of loans and that on housing loans posted significant declines (particularly for variable rate loans), especially in May and most likely ascribable to the benchmark index for loans to consumers becoming effective that month. The average lending rate on new business to non-financial corporations recorded a somewhat more sizeable advance (up 0.18 percentage points, to 6.36 percent), on account of developments across both major types of loans (below and above EUR 1 million equivalent respectively; Chart 3.4). The average remuneration of new time deposits from households resumed growth, albeit at a slower pace (up 0.08 percentage points to 1.70 percent), whereas that of new time deposits from non-financial corporations went down 0.25 percentage points to 2.24 percent, amid some monthly fluctuations, correlated with the evolution of shorter-term rates on the interbank money market.

52 The average accepted rates remained relatively stable in May, except for those on 5-year securities, which inched up 0.22 percentage points.

53 Specifically, during the reported quarter overall, the ratio of the amounts of bids submitted to the announced volume climbed to 2.1 versus 1.7 in the previous three months, while the ratio of the volume of issues to the announced volume advanced to 124 percent from 85 percent. At the same time, the average maturity of government securities issued extended slightly against that recorded January through March (to 5.8 years from 5.5 years).

54 Moreover, the MPF launched in Q2 new issues of government securities intended exclusively for households, issuing in April, May and June securities totalling lei 793.5 billion, with maturities ranging between 1 and 5 years and interest rates between 3.5 percent and 5.0 percent. In addition, May saw the putting into circulation on the domestic market of EUR-denominated government securities with a residual maturity of 1.8 years and 4.6 years respectively, worth EUR 229 million and EUR 194 million respectively, at 0.21 percent and 0.84 percent rates respectively.

Chart 3.5. Nominal exchange rate

Table 3.1. Key financial account items

EUR million

	5 mos. 2018			5 mos. 2019		
	Net acquisition of financial assets*	Net incurrence of liabilities*	Net	Net acquisition of financial assets*	Net incurrence of liabilities*	Net
Financial account	1,710	3,787	-2,077	2,803	4,184	-1,381
Direct investment	641	2,263	-1,622	1,232	2,717	-1,485
Portfolio investments	147	1,673	-1,525	958	1,487	-529
Financial derivatives	x	x	70	x	x	-14
Other investment	1,519	-148	1,667	1,106	-20	1,126
– currency and deposits	556	-450	1,006	65	-621	686
– loans	32	-1,352	1,384	-138	-1,046	908
– other	931	1,654	-723	1,179	1,647	-468
NBR's reserve assets, net	-667	0	-667	-479	0	-479

*) "+" increase/"-" decrease

2.2. Exchange rate and capital flows

In the first two months of 2019 Q2, the EUR/RON exchange rate remained quasi-stable at the higher values recorded at the beginning of the year, before posting a relatively sharp downward correction towards the end of May and in the first days of June – in tandem with developments in the region (Chart 3.5).

The EUR/RON saw its fluctuations subside immediately after the approval of the revised configuration of the tax on credit institutions' financial assets[55], before quasi-stabilising in April only slightly below the historical peak recorded at the beginning of the year, in an environment featuring, on the one hand, a pick-up in inflation and a widening of the trade deficit and current account deficit and, on the other hand, the tightening of money market conditions and the improvement in international financial market sentiment, due mainly to the temporary alleviation of concerns over the global economic slowdown. The almost linear path of the currency pair extended into most of May, amid the influences coming from the central bank's strict control over money market liquidity, but also from the further worsening in the external position of the economy and the rekindled global risk aversion, under the impact of the re-escalating trade row[56] (Table 3.1). The latter affected more strongly the exchange rates of the main currencies in the region, which embarked at the onset of the period and thereafter remained on an upward trend.

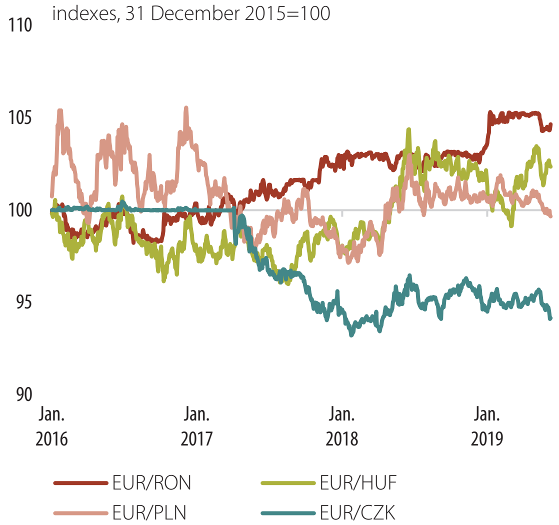
However, at end-May and in the first days of June, the EUR/RON witnessed a relatively sharp downward correction, in tandem with the exchange rates of the other currencies in Central and Eastern Europe, and subsequently remained at the lower values thus reached, amid investors' expectations and signals from the Fed and ECB on a

55 Pursuant to GEO No. 19/2019, approved by the Government on 29 March.

56 On 5 May, the US President announced the increase in tariffs on USD 200 billion of Chinese imports from 10 percent to 25 percent – effective as of 10 May –, as well as the application, in the near future, of a new 25 percent duty on another USD 325 billion of imports not already covered. In response, on 13 May, China announced the increase in tariffs on US imports worth USD 60 billion.

Chart 3.6. Exchange rate developments on emerging markets in the region

indexes, 31 December 2015=100



Source: ECB, NBR

forthcoming easing of the monetary policy stance[57], conducive to an increase in the attractiveness of investments on financial markets in the region[58] (Chart 3.6).

April through June, transactions on the interbank forex market continued to post a deficit, which narrowed after the significant widening in the previous three months, yet amid a considerable rise in residents' net demand for foreign currency, up to a five-quarter high.

During 2019 Q2 as a whole, the leu strengthened versus the euro by 0.6 percent in nominal terms[59] and by 1.4 percent in real terms. In relation to the US dollar, the domestic currency appreciated by 0.5 percent in nominal terms and 1.3 percent in real terms, given that the former saw no significant changes against the euro on international markets. Looking at the average annual exchange rate dynamics in 2019 Q2, the leu saw its nominal depreciation widen against the euro and diminish versus the US dollar.

2.3. Money and credit

Money

The annual dynamics of broad money[60] slightly picked up in April-May 2019, for the first time in the past five quarters (9.5 percent from 9.3 percent in 2019 Q1; Table 3.2)[61], yet witnessed larger fluctuations. Specifically, it increased significantly in April – owing to the budget execution and use of European funds[62] –, but posted a decline just as strong the following month, amid the contraction in annual terms of the disbursements from the government budget to recipients of EU funds, as well as the renewed step-up in the dynamics of the portfolio of alternative financial instruments

57 On 6 June, the ECB adjusted its forward guidance on the key interest rates, extending the time period over which it intends to maintain them at the current levels (at least through the first half of 2020), and afterwards President Draghi said that an additional stimulus would be required if the economic outlook did not improve. At the same time, at the beginning of June, Fed officials declared that a possible escalation of the trade war may prompt the central bank to act in order to alleviate its impact on the US economy. In the statement on the monetary policy decision of 19 June, the Fed showed that, in light of the rising uncertainties about the outlook on economic activity and on inflation, as well as of muted inflationary pressures, it would closely monitor the implications of incoming information for the economic outlook and would act as appropriate to sustain economic expansion, with a strong labour market and annual inflation near the 2 percent objective.

58 Also considering that the first-quarter GDP growth figures released in that period showed the resilience of Central and Eastern European economies to the slower growth in the euro area (economic advance exceeded expectations in Romania, Poland and Hungary and confirmed them in Czechia).

59 The Czech koruna and the Polish zloty also strengthened against the single currency, by 0.3 percent and 0.8 percent respectively, whereas the Hungarian forint depreciated by 2.1 percent.

60 Unless otherwise indicated, percentage changes in this section refer to the average of annual growth rates in nominal terms.

61 However, in real terms, the average annual M3 dynamics remained on a downward trend, reaching 5.2 percent in the first two months of 2019 Q2, from 5.4 percent in 2019 Q1.

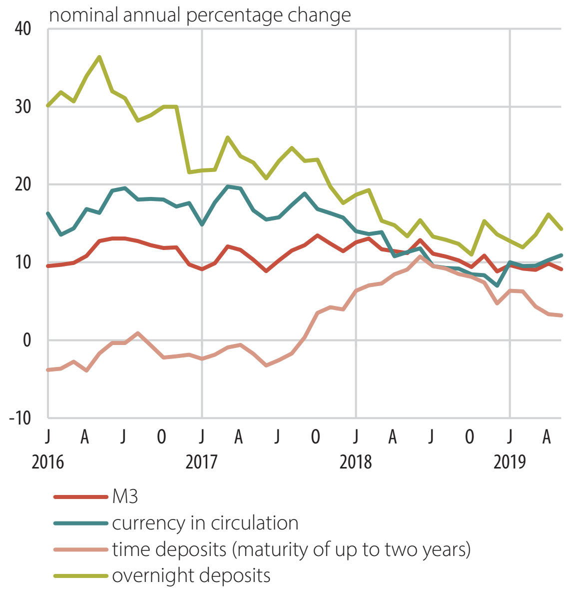
62 According to general government budget execution data.

Table 3.2. Annual growth rates of M3 and its components

nominal percentage change

	2018			2019		
	II	III	IV	I	Apr.	May
	quarterly average growth					
M3	11.8	10.7	9.7	9.3	9.9	9.1
M1	13.5	11.8	11.7	11.8	14.4	13.3
Currency in circulation	11.3	9.3	8.0	9.7	10.3	10.9
Overnight deposits	14.5	12.9	13.3	12.7	16.1	14.3
Time deposits (maturity of up to two years)	9.4	9.1	6.8	5.7	3.3	3.2

Chart 3.7. Main broad money components



in lei held by non-bank entities in comparison to the previous year (government securities)[63].

The step-up in M3 growth was due solely to the faster pace of increase of narrow money (at a 5-quarter high), stemming mainly from developments in household and corporate overnight deposits and, to a lower extent, from the annual rate of change of currency in circulation, which reached a 11-month high in May (Chart 3.7). By contrast, the dynamics of time deposits with a maturity of up to two years continued to slow down (to a 7-quarter low), primarily on the back of household deposits, whose loss of momentum throughout the period was reflected in both lei-denominated deposits (inter alia amid the further increase in government securities investments[64] and the interest rates on new time deposits remaining slightly below the values reached at end-2018) and foreign currency-denominated deposits. As for similar deposits from non-financial corporations, the decline in annual dynamics (to a 2-year low) was solely ascribable to the foreign currency component, as the lei component halted its downtrend. In this context, the share of M1 in M3 continued to widen, reaching 62 percent in April – a new post-November 1994 record high.

The broad money breakdown by holder reveals the rebound in the pace of increase of total M3 deposits of non-financial corporations, due to a stronger growth in April, followed by a relative slowdown in May – both developments were associated with the changes in the annual dynamics of government spending on subsidies, as well as of payments for certain tax categories, to which added dividend payments made by some companies in the second month of the quarter. Conversely, the pace of increase in household deposits decelerated marginally, as the acceleration recorded in April – correlated with faster dynamics of some income categories (wages, social security benefits[65], EU funds[66]), as well as with a significant volume of government securities in this sector's portfolio

63 In May, the annual pace of increase of leu-denominated government securities held by corporations and households (including those aimed exclusively at individuals) picked up from the previous month, standing slightly below the post-June 2015 high recorded in March 2019.

64 April through May 2019, the MPF issued government securities worth a total of lei 562.4 million targeting exclusively households.

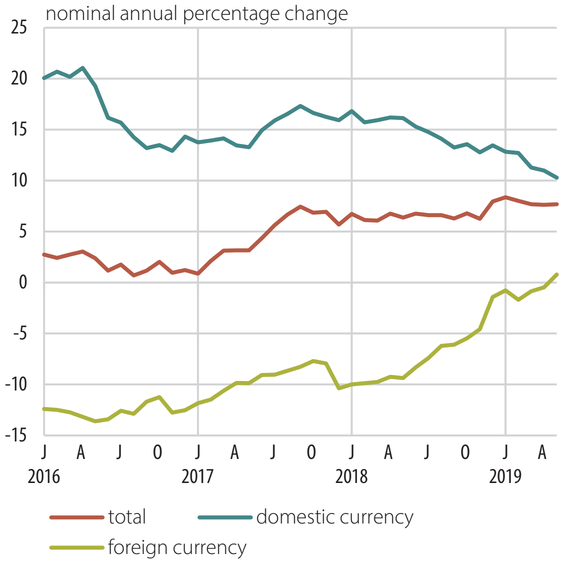
65 According to general government budget execution data.

66 According to the data on general government spending for projects financed from non-repayable external funds, along with the data from the Agency for Rural Investment Financing regarding disbursements from EU funds for agriculture. The breakdown of these amounts by group of recipients is not possible.

reaching maturity[67] – was followed by a slowdown. The latter occurred on the back of the slacker growth of disbursements from EU funds and the shift of larger sums to government securities investments.

Looking at M3 counterparts, the pick-up in its average annual dynamics mainly reflected (i) the steeper decline in central government leu-denominated deposits during the two months as a whole, (ii) the significant step-up in the rate of change of the net foreign assets of the banking system[68], though concurrently with the swifter growth rate of central government forex deposits, and, to a smaller extent, (iii) the slower advance in long-term financial liabilities[69]. Contractionary effects were exerted primarily by the drop in the annual dynamics of government credit.

Chart 3.8. Credit to the private sector by currency



Credit to the private sector

The annual growth rate of credit to the private sector halted its downward trend, remaining relatively unchanged in April and May, at 7.6 percent and 7.7 percent respectively. Over these two months as a whole, it slowed down slightly compared to the 7-year high recorded in the previous quarter, i.e. 8.0 percent (Chart 3.8). This evolution reflected opposite movements in the dynamics of the components. Specifically, the annual increase in leu-denominated loans stuck to double-digit levels, yet continued to decelerate slowly (reaching an almost 4-year low), as the renewed rise in annual terms in new loans and the decline in the volume of non-performing loans removed from banks' balance sheets were offset by the weaker dynamics of overdraft loans and revolving credit and of credit by cards, as well as by the probable step-up in debt repayments. However, the foreign currency component (expressed in euro) further accelerated its annual dynamics, which thus marginally re-entered positive territory after approximately 7 years, solely on the back of developments on the non-financial corporations segment. The latter reflected the swifter increase, in the reported period as a whole, in loans through lines of credit, as well as the lower impact of loans removed from banks' balance sheets. Nevertheless, the share of domestic currency loans in total private sector credit further widened, reaching 66.2 percent in May – a post-July 1996 high.

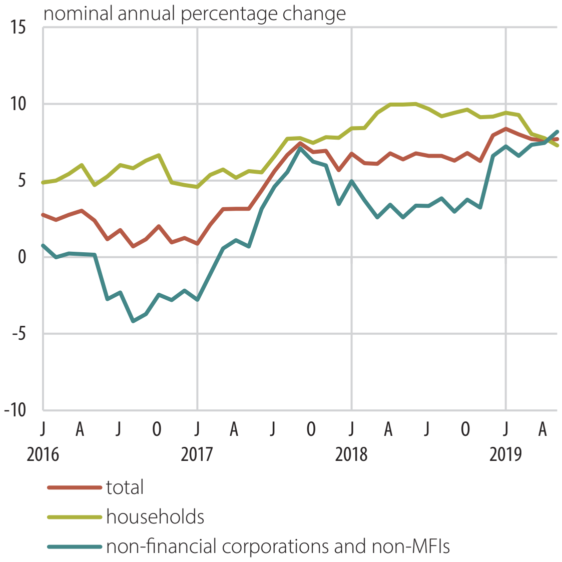
The breakdown by institutional sector also points to divergent developments. Specifically, the annual growth rate of loans to non-financial corporations continued to increase in the reported period as a whole, reaching a new post-August 2012 record in May. The pattern was yet again ascribable to the annual rate of change of the foreign currency component (expressed in euro), which remained relatively

67 At end-April, government bonds worth lei 8.8 billion reached maturity.

68 Given that, in April, the MPF issued bonds worth EUR 3 billion on the external market.

69 Capital accounts included.

Chart 3.9. Credit to the private sector by institutional sector



unchanged in April[70] before advancing markedly in May (a post-December 2010 high), mainly owing to new loans, but also to overdraft loans and revolving credit. The lei component, however, continued to reduce its annual growth – the marginal rebound in pace in April was followed by a new slowdown –, prompted by the decrease in the rate of change of new loans, partly offset by the smaller negative contribution of loans removed from credit institutions' balance sheets.

Conversely, the annual increase in household credit further followed a downtrend, reaching a 7-quarter low (Chart 3.9). The deceleration was determined by the lei component, whose dynamics remained at double-digit levels, yet slowed down, on the back of both housing loans – which were also influenced by the continued decline in the contribution of "First Home" loans[71] – and consumer credit. The latter's growth rate saw a renewed step-up in May amid the record increase in the volume of new loans, yet significantly contracted April through May compared with 2019 Q1, mainly due to the base effect associated with including a new credit institution in the aggregate monetary balance sheet in the previous year[72]. However, the annual pace of contraction of foreign currency loans to households (expressed in euro) held steady.

70 The impact of the decline in the volume of non-performing loans removed from banks' balance sheets was mostly offset by the slacker dynamics of new loans and of overdrafts and revolving credit.

71 According to CCR data referring to loans granted with state guarantee associated with the "First Home" programme.

72 March 2018 saw the start of operations on the local market of BNP Paribas Personal Finance Paris, Bucharest branch, following its merger with Cetelem IFN.

4. Inflation outlook

The annual CPI inflation rate is projected to reach 4.2 percent at end-2019, 3.4 percent at end-2020 and 3.3 percent at the forecast horizon, i.e. 2021 Q2. Against the previous *Inflation Report*, the current projection was revised only for the end of next year (+0.1 percentage points). The unfavourable shocks seen earlier this year play a major role in the expectations on the CPI inflation rate remaining until year-end at levels above the upper bound of the variation band of the target. Adding to these unforeseen shocks are the stronger inflationary pressures coming from fundamentals, reflected largely by the path of core inflation. Inflation expectations will remain above the variation band of the central target until the end of this year, before returning inside the band. At the same time, the annual CPI inflation rate will return into the upper half of the variation band in 2020 Q1 after the dropping-out from the price index of the impact of year-ago inflation shocks. Over the same period, also amid base effects associated with the fading-out of influences from the hikes in prices for telecom services in the first part of 2019, the adjusted CORE2 inflation is projected to drop somewhat. Subsequently, the annual core inflation is expected to stabilise at levels marginally higher than the upper bound of the variation band of the target, reaching 3.6 percent at end-2020 and at the projection horizon. The impact of receding inflation expectations at this horizon is foreseen to be offset by the persistent excess demand and the mild increase in inflationary pressures from import prices influenced by the gradual rise in external inflation. The balance of risks to the annual inflation projection is assessed to be tilted to the upside compared to its path in the baseline scenario, owing to domestic factors in particular.

1. Baseline scenario

1.1. External assumptions[73]

Over the projection interval, external demand, assessed based on the effective EU GDP (EU-28 excluding Romania), is expected to increase at annual rates around 1.5 percent (Table 4.1), below the level of 2018 (2.1 percent) and slightly lower than those in the previous *Report*. This revision owed largely to the weak performance across manufacturing, amid escalating trade tensions and heightened uncertainties, both factors putting a heavier drag on global activity. Above-expectations economic performance in 2019 Q1, amid some incidental factors (larger inventories in the UK

[73] Source: NBR assumptions based on data provided by the European Commission, ECB, Consensus Economics and Bloomberg (futures prices).

Table 4.1. Expectations on the developments in external variables

annual averages

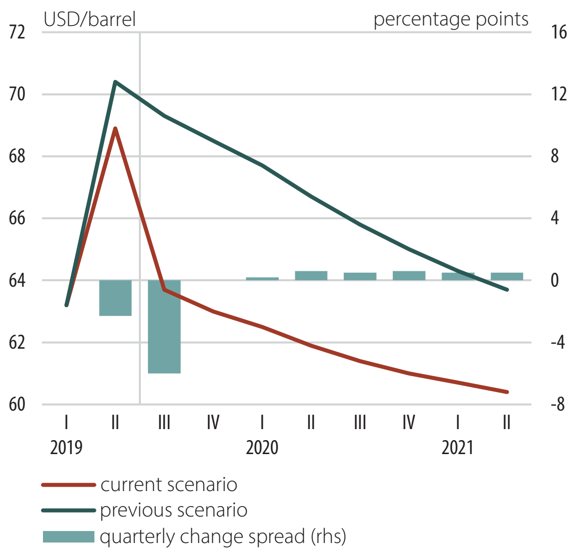
	2019	2020
Effective EU economic growth (%)	1.5	1.5
Annual inflation rate in the euro area (%)	1.3	1.4
Annual inflation rate in the euro area, excluding energy (%)	1.2	1.5
Annual CPI inflation rate in the USA (%)	1.8	2.1
3M EURIBOR (% per annum)	-0.3	-0.4
USD/EUR exchange rate	1.13	1.16
Brent oil price (USD/barrel)	64.7	61.7

Source: NBR assumptions based on data provided by the ECB, European Commission, Consensus Economics and futures prices

ahead of the original Brexit deadline, a mild winter that fuelled construction, particularly in Germany, and the recovery of the automotive industry), is seen losing momentum over the next periods. In the medium term, however, economic activity will be underpinned further by the ECB's persistently accommodative monetary policy, solid private consumption (boosted by fiscal measures and real income dynamics) and business investment. The effective EU GDP gap, an indicator reflecting the cyclical component of economic activity in Romania's main trading partners, is seen further posting positive values, with a stimulative impact on the domestic economy.

The average annual HICP inflation rate in the euro area is forecasted to further stay below the 2 percent benchmark (the ECB's implicit inflation target), despite higher wage costs borne by companies, which accepted to cover these expenses from profit margins (amid persistently weak demand and increased uncertainties as well as under the impact of soft inflationary pressures stemming from energy prices). The average annual HICP inflation rate excluding energy in the euro area – the relevant measure for shaping the path of prices of imported goods – will follow an upward path over the projection interval, from 1.2 percent in 2019 to 1.5 percent in 2020, a level revised marginally downwards than in the previous *Inflation Report*, amid the bloc's slower-than-previously-expected economic activity. Annual inflation rate in the USA is foreseen to run higher than in the euro area in both years, and exceed the 2 percent level in 2020.

Chart 4.1. Brent oil price scenario



Source: U.S. Energy Information Administration, NBR assumptions based on Bloomberg data

Against the background of the ECB's persistently accommodative policy[74], which was enhanced by the institution's decisions made since the release of the previous *Inflation Report*, the nominal 3M EURIBOR rate is anticipated to further register negative values throughout the projection interval.

The EUR/USD exchange rate foresees a slight strengthening of the euro throughout the forecast interval, reaching USD 1.17 per euro at the projection horizon, compared to the level seen in 2019 Q2, i.e. USD 1.12 per euro. The path of the currency pair is, however, saddled with high levels of uncertainty, given the swings in the exchange rate of the two currencies and the monetary policy stance in these two economies.

[74] In its 6 June 2019 meeting, the ECB's Governing Council decided to leave unchanged the key ECB interest rates at least through the first half of 2020, and in any case for as long as necessary to ensure the continued sustained convergence of inflation to levels that are below, but close to, 2 percent. Moreover, the Governing Council decided upon the modalities of the new series of targeted longer-term refinancing operations (TLTRO III).

The scenario for the developments in the international Brent oil price, based on futures prices, foresees a slightly descending trend throughout the projection interval, down to levels around USD 60 per barrel at the forecast horizon (Chart 4.1). The trajectory runs below that anticipated previously, amid lower global economic growth owing to trade rows. Nonetheless, the evolution is marked by high uncertainty, as mirrored also by the revised trajectories of futures prices in the successive projection rounds. The future dynamics of the oil price are conditional on both supply-side factors (a broader cut in OPEC+ countries' oil production, geopolitical tensions, uncertainties around shipping routes in the Gulf of Oman and the Persian Gulf, larger US shale oil and gas production) and demand-side factors (US-China trade dispute, sluggish global economic growth that may weigh on energy consumption).

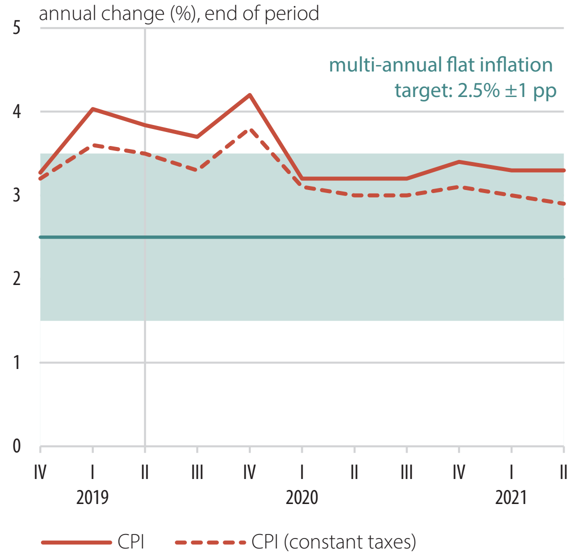
Table 4.2. The annual inflation rate in the baseline scenario

annual change(%), end of period

	2019		2020				2021	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Central target	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
CPI projection	3.7	4.2	3.2	3.2	3.2	3.4	3.3	3.3
CPI projection*	3.3	3.8	3.1	3.0	3.0	3.1	3.0	2.9

*) calculated at constant taxes

Chart 4.2. Inflation forecast



Source: NIS, NBR projection

1.2. Inflation outlook

The annual CPI inflation rate is foreseen to reach 4.2 percent at end-2019, 3.4 percent at end-2020 and 3.3 percent at the projection horizon, i.e. 2021 Q2 (Table 4.2, Chart 4.2). Under the impact of unfavourable shocks in the first part of the year, this indicator is expected to stay outside the variation band of the central target during 2019 H2 as well[75]. Subsequently, the annual inflation rate will slip into the upper half of the variation band of the target in 2020 Q1, following the fading-out of effects of year-earlier inflationary shocks. The levels projected by the end of the forecast interval follow a relatively stable path.

The annual inflation rate at constant taxes is assessed at lower levels than those of headline inflation over the entire projection interval, with the contribution of indirect tax changes[76] being estimated at 0.4 percentage points at end-2019, 0.3 percentage points at end-2020 and 0.4 percentage points at the projection horizon. The average annual CPI inflation rate, a more persistent indicator, is anticipated to fall until 2019 Q3, down to 3.8 percent, and to remain around this level for approximately two quarters, before resuming its decline and touching 3.3 percent at end-2020 and at the projection horizon.

75 There will also be transitory fluctuations in the near run, also possibly pushing inflation above 4 percent, amid opposite developments in the exogenous components of inflation (costlier tobacco products, cut in the natural gas price) and specific seasonal effects (relative to volatile food prices). These swings will be influenced also by base effects expected to become manifest at the end of this year, associated with favourable supply-side shocks in the latter part of 2018, i.e. declines in international oil prices and citrus fruit prices on the markets of origin.

76 Largely the hike in excise duties on tobacco products and fuels.

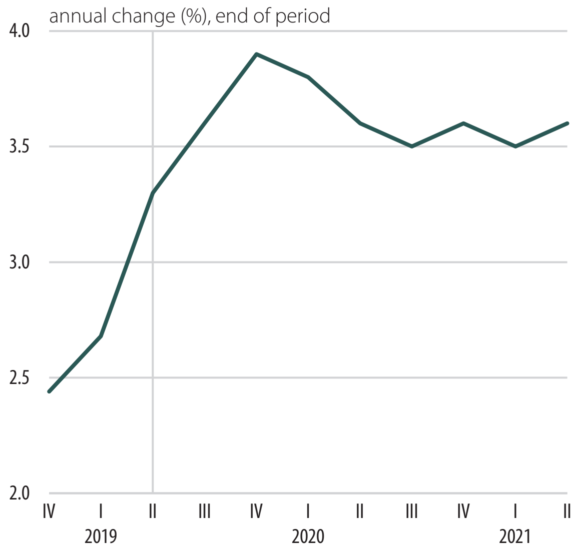
Compared to the May 2019 *Inflation Report*, the annual CPI inflation rate is projected at a similar level at the end of 2019, being revised upwards by 0.1 percentage points in December 2020. For 2019, the upward revision of projections for core inflation and the dynamics of tobacco product prices is offset by the expected developments in fuel prices and administered prices. For 2020, the reassessment is chiefly driven by the upward revision of the outlook for core inflation.

Table 4.3. Annual adjusted CORE2 inflation rate in the baseline scenario

annual change (%), end of period

	2019		2020				2021	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Adjusted CORE2	3.6	3.9	3.8	3.6	3.5	3.6	3.5	3.6

Chart 4.3. Annual adjusted CORE2 inflation



Source: NIS, NBR projection

Table 4.4. Components' contribution to annual inflation rate*

percentage points

	2019	2020
Administered prices	0.2	0.4
Fuels	0.4	0.2
VFE prices	0.7	0.2
Adjusted CORE2	2.4	2.2
Tobacco and alcoholic beverages	0.5	0.3

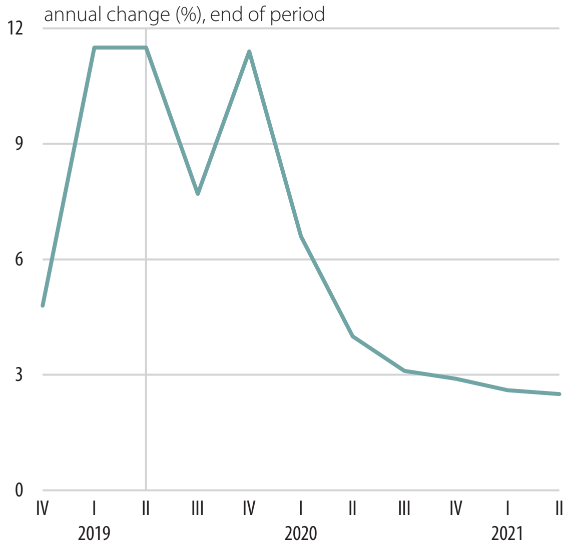
*) end of period; values have been rounded off to one decimal place

The annual adjusted CORE2 inflation rate is forecasted to stay on an upward course until the end of 2019, when it is set to peak at 3.9 percent (Table 4.3, Chart 4.3). This will be the result of hikes in prices for some telecommunication services implemented earlier this year as well as of stronger inflationary pressures from fundamentals, excess demand and inflation expectations in particular. The latter are seen persisting above the variation band of the central target until the end of 2019, before returning inside the band, yet remaining in its upper half over the medium term. Additional inflationary pressures stem from the negative supply-side shock at global level associated with African swine fever in China. In the first part of 2020, core inflation is projected to lose some steam, due mainly to the fading-out of the influences associated with this year's hikes in prices for telecom services. Subsequently, the annual adjusted CORE2 inflation rate is expected to stabilise at levels marginally higher than the upper bound of the variation band of the target, reaching 3.6 percent at end-2020 and at the projection horizon. The impact of receding inflation expectations at this horizon is foreseen to be offset by the persistent excess demand and the mild increase in inflationary pressures from import prices, under the impact of gradually rising external inflation.

Compared to the May 2019 *Inflation Report*, the annual adjusted CORE2 inflation rate was revised upwards by 0.1 percentage points for the end of 2019 and 2020 respectively. The revision owes to inflation expectations seen shifting to higher values throughout the projection interval, as well as to stronger inflationary pressures from excess demand. The influence of these factors is only partly countered by the lower-than-previously-anticipated impact of the hikes in prices for telecom services and by the downward reassessment of the annual HICP inflation rate excluding energy in the euro area, with a relatively more favourable influence on import prices.

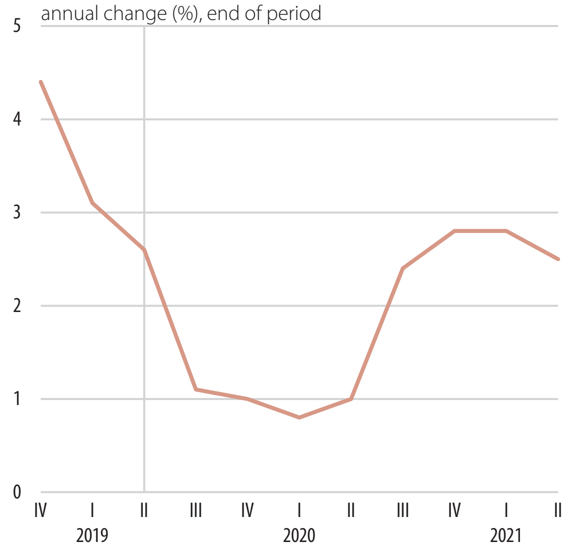
The cumulative contribution of inflation components beyond the scope of monetary policy, namely administered prices, volatile food (VFE) prices, fuel prices and tobacco product and alcoholic beverage prices, to the annual CPI inflation rate is seen at 1.7 percentage points at end-2019 (a value revised marginally downwards by 0.1 percentage points versus the May 2019 *Inflation Report*) and 1.1 percentage points at the end of next year, a level similar to that projected in the previous round (Table 4.4).

Chart 4.4. VFE prices annual inflation



Source: NIS, NBR projection

Chart 4.5. Administered prices annual inflation



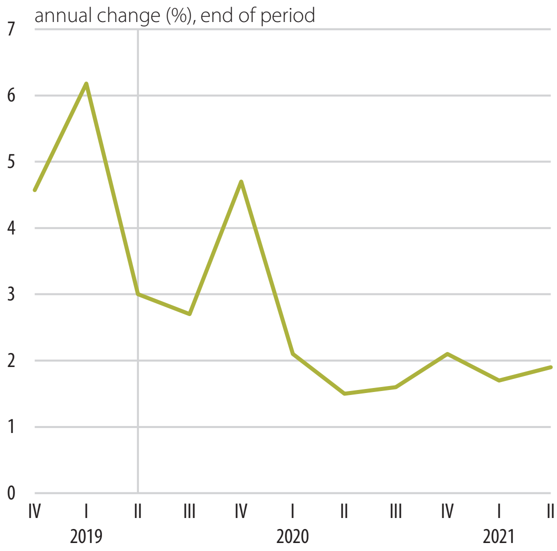
Source: NIS, NBR projection

Volatile food (VFE) prices are projected to go up at an annual pace of 11.4 percent at the end of 2019 and 2.9 percent at the end of 2020, both values being relatively similar to those in the prior *Report* (Chart 4.4). Their path is shaped by the significant hikes recorded at the beginning of 2019 in Europe (amid bad weather conditions) and by the assumption of a normal harvest for 2020, which would entail lower inflationary pressures associated with this component at this horizon.

According to the baseline scenario for administered prices, their annual growth rate is anticipated at 1 percent and 2.8 percent at the end of 2019 and 2020 respectively (Chart 4.5). Compared to the previous *Inflation Report*, the projection for the end of this year was subject to a 0.9 percentage point downward revision, largely on the back of the cut in regulated prices of natural gas delivered to households[77]. For the end of next year, the projected level is similar to that envisaged in the previous round in the absence of new relevant information for this time horizon.

77 Following the meeting of 24 June 2019, the Regulatory Committee of the Romanian Energy Regulatory Authority approved the prices for regulated supply of natural gas to households. The main affected component was the selling price of domestic gas producers, which was capped at lei 68/MWh. The effects of the measure underlying the price adjustment were not fully incorporated into the previous projection, given the elevated uncertainty surrounding the provisions of GEO No. 114/2018, as amended by GEO No. 19/2019. For further details, see the Romanian Energy Regulatory Authority press release of 24 June 2019, available at: https://www.anre.ro/ro/presa/comunicate/comunicat-24-06-2019-privind-preturile-pentru-furnizarea-reglementata-a-gazelor-naturale-la-clientii-casnici (Romanian only).

Chart 4.6. Fuel prices annual inflation



Source: NIS, NBR projection

The annual dynamics of fuel prices are anticipated to reach 4.7 percent at end-2019, being revised downwards by 1.7 percentage points, and 2.1 percent at end-2020, following an upward revision of 0.4 percentage points (Chart 4.6). The group's inflation path is influenced by the negative annual dynamics of the international oil price over the entire forecast interval (yet saddled with great uncertainties) and by the projection of a rising euro against the US dollar, impacting the USD/RON exchange rate and, in turn, the leu-denominated fuel prices.

The annual price dynamics projected for tobacco products and alcoholic beverages are envisaged at 6.7 percent and 4.2 percent at end-2019 and end-2020 respectively. The evolution of these prices is influenced by the increase, unforeseen in the previous projection, by lei 0.50 in the price of cigarettes in July this year (the forecast was revised upwards by 2.4 percentage points for the end of 2019). The scenario also considered the tobacco companies' past behaviour in terms of final price adjustment following the implementation of changes in fiscal policy.

1.3. Demand pressures in the current period and over the projection interval[78]

Output gap

In 2019 Q1, real GDP saw a new rebound in its quarterly growth rate (to 1.3 percent, 0.3 percentage points above that of 2018 Q4), which led to a stronger-than-anticipated step-up in its annual dynamics, up to 5 percent[79]. The quarterly GDP growth mirrored consumption remaining the key driver, as well as GFCF making a new positive contribution (albeit more moderate compared to the values of the 2018 H2). At the same time, net exports had a negative contribution, albeit declining compared to the previous quarter, given that the quarterly dynamics of exports slightly exceeded those of imports[80].

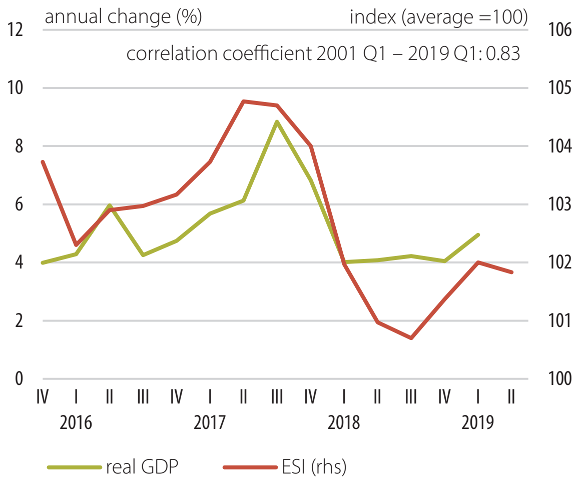
In the next two quarters, quarterly GDP growth is foreseen to continue, yet at a slower pace compared to 2019 Q1. The forecast embodies weakening signals from high-frequency indicators such as industrial output, retail trade turnover volume or real net wage earnings (influencing domestic demand) – the last ones witnessing a notable quarterly advance in 2019 Q1. Other signs, yet mixed, on the GDP

78 Unless otherwise indicated, percentage changes are calculated based on seasonally adjusted data series. Source: NBR, MPF, NIS, Eurostat, EC-DG ECFIN and Reuters.

79 According to NIS Press Release No. 170 of 8 July 2019, real GDP increased by 4.1 percent in 2018 Q4 versus the same quarter in 2017. Annual dynamics are calculated based on gross data series.

80 For details on recent developments in economic activity, see Chapter 2, Section 1. Demand and supply.

Chart 4.7. Economic sentiment indicator* and economic growth



*) seasonally adjusted data

Source: NIS, EC-DG ECFIN

outlook are provided by the economic sentiment indicator[81] (Chart 4.7). Moreover, GDP developments in the period under review may be influenced by the notable historical volatility of agricultural performance, which triggers uncertainty regarding the forecast. The breakdown shows that quarterly GDP growth is assessed to further be ascribed to consumption. At the same time, GFCF is projected to maintain its positive low contribution, whereas net exports of goods and services are forecasted to have new increasing negative contributions.

For 2019, the baseline scenario of the projection shows the annual increase in GDP to be similar to that recorded in 2018, and for next year it sees the dynamics slightly decelerating and gradually getting close to the potential rate. The path of the GDP is further marked by uncertainty, which is fuelled, among others, by the frequent legislative changes affecting GFCF, and implicitly GDP and potential GDP[82], in the long term, as well as by the relatively substantial recent contribution from the change in inventories. Over the projection interval, final consumption is expected to remain the driver of economic growth, in a proportion close to that of 2018. After the decline recorded a year earlier, GFCF is projected to make a positive contribution, marked however by high uncertainties associated also to the frequent changes of this component's historical data. Albeit slightly on the wane, the contribution of net exports is forecasted to remain negative, amid a systematically protracted slowing trend in the growth of exports of goods and services relative to the dynamics of imports. For 2019, a new substantial allocation to the change in inventories is expected, mainly determined by the notable carry-over effect from the previous year that would be hard to be ascribed to unequivocal economic behaviours.

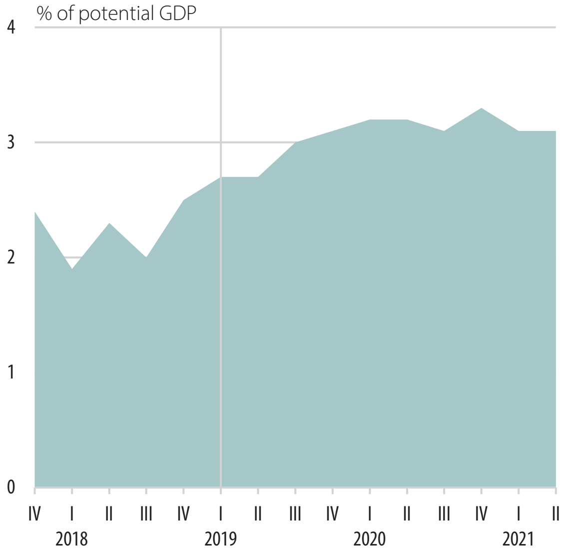
Annual growth of potential GDP is anticipated to pick up moderately, against the background of robust capital accumulation, of a further slightly positive contribution from labour and, in this context, of a relative recovery in total factor productivity (TFP). Compared to the previous *Inflation Report*, the path of potential GDP was revised upwards, due to the incorporation of the favourable revision of GFCF recent historical data and outlook in the contributions coming from capital stock and TFP. However, the assumption of levelled-off dynamics of TFP over the forecast interval persists, reflecting structural deficiencies of the economy (modest allocation of resources for

81 The indicator's breakdown shows that during 2019 Q2 the consumer and construction components were on the rise, whereas confidence in industry, services and trade moved in the opposite direction.

82 For instance, the provisions of GEO No. 114/2018, subsequently supplemented by GEO No. 19/2019, may affect companies' investment plans, particularly those in the energy and telecommunications sectors. In this respect, the Box entitled "Recent developments in investment: several coordinates" in the February 2019 *Inflation Report* looks at the inhibitive role played by uncertainty and the level of indebtedness on capital accumulation and on the start of investment projects, respectively. Various sources that might exert adverse effects on economic activity are detailed in Chapter 4, Section 1.4. Risks associated with the projection of this *Report*.

innovation, low quality infrastructure, high skill mismatch[83]), to which add adverse influences inherent to the uncertainty around the instability of the legal framework. Efficiency gains might occur from an improved absorption of EU structural and investment funds[84] and from a rise in foreign direct investment inflows[85] (which may, however, be affected by the weaker outlook for economic growth in the main countries of origin). Even in the context of continuing unfavourable demographic trends (ageing of population, emigration), the contribution from labour is expected to remain slightly positive, mainly on account of an upward trend in the activity rate, in parallel with economic growth.

Chart 4.8. Output gap



Source: NBR assessments based on data provided by the NIS

The output gap (Chart 4.8) is foreseen to follow a gradual upward path in the first part of the projection interval, before flattening out somewhat. This trajectory reflects: (i) stronger stimuli associated with the discretionary component of fiscal policy, based on significant increases in the pension point[86]; (ii) a further stimulative nature of real broad monetary conditions, but abating to relatively neutral values during the latter part of the forecast interval; (iii) a persistent effective external demand in excess, against the background of its pace of increase nearing its potential rate, with a stimulative impact on economic activity in Romania. From the perspective of aggregate demand components, the output gap path is shaped by the developments in the gap of actual individual consumption of households, while the cyclical component of GFCF makes an almost nil contribution. In turn, the gaps of exports and imports of goods and services are assessed at positive values, yet their net contribution to the output gap remains negative. The assessment of the output gap and of the GDP components' gaps is surrounded by a notable degree of uncertainty mirroring their high volatility, as well as the frequency and size of the historical series revisions.

Compared to the previous *Inflation Report*, the projected output gap is wider, encompassing the more stimulative impact coming from real broad monetary conditions (caused by an increased contribution from real interest rates) and from the fiscal impulse (in 2019, but with lasting effects for the remainder of the projection interval).

[83] Related evidence is brought by the *European Innovation Scoreboard* analysis of the EC, the *Ease of Doing Business* ranking of the World Bank or the *Global Competitiveness Index* of the World Economic Forum.

[84] According to the *Net Financial Balance* published by the MPF, in 2019 H1 structural and cohesion funds inflows totalled EUR 1.3 billion, which was an outstanding figure for that period of the year within the Multiannual Financial Framework 2014-2020.

[85] The Box entitled "The impact of foreign direct investment in the Romanian economy" in the NBR *Annual Report* for 2018 shows the significant contribution of foreign-owned firms to economic (including structural) growth, as they have higher levels of labour productivity, compensation of employees and investment intensity compared to local firms.

[86] In September 2019 (by 15 percent), September 2020 (by approximately 40 percent) and September 2021 (by around 6 percent).

Aggregate demand components

Final consumption saw its quarterly dynamics further decelerate down to 1 percent in 2019 Q1, mainly on the back of the slower quarterly increase in the actual individual consumption of households. In the short term, the quarterly growth rates are expected to post similar values, fuelled by the rise in households' real disposable income, by the improved consumer confidence and by the impact, anticipated to remain stimulative, of real interest rates.

Over the projection interval, final consumption will remain the key driver of economic growth, given the expected modest positive contributions from GFCF and the negative ones from net exports (forecasted to slightly narrow in 2020). The projected dynamics of final consumption will be chiefly supported by the robust expansion of the actual individual consumption of households, due to the rise in households' real disposable income. This is forecasted to maintain its annual dynamics at values similar to those in 2018, on the back of the wage component and of the social transfers entailed by the stages of increase in the pension point. The raise in wages will also reflect the relatively high degree of labour market tightness, amid the persistent constraints of structural factors. Moreover, the hike in the minimum wage economy-wide and the pay rises in the public sector, both enforced at the beginning of 2019, are relevant to the dynamics of the wage component in the current year.

In 2019 Q1, GFCF grew by 1.3 percent quarter on quarter. The annual GFCF dynamics returned to positive territory (3.9 percent, following the negative values recorded in the previous three quarters). In the short term, GFCF is anticipated to maintain a quarterly advance similar to that in 2019 Q1. The forecast mirrors the recovery of construction and the preservation of economic sentiment, on the one hand, and mixed developments for the sub-components of industrial production, on the other.

Following the contraction recorded throughout 2018 (on the back of the unfavourable developments in the construction component), the annual dynamics of gross fixed capital formation are expected to recover, reflecting the upturn of the mentioned component during 2019. This path is marked by uncertainty, on the background of: (i) the frequent legislative changes, with potential unfavourable effects on companies' investment plans, (ii) the authorities' discretionary investment stance[87] (which entailed, in successive rounds, a decline in fund allocations to this spending category), (iii) structural factors such as poor quality of infrastructure and recruitment difficulties due to the shortage of skilled workforce (the automotive industry being the main example in this respect) and (iv) the volatile structure and the large revisions of the data released by the NIS in real time. Nevertheless, GFCF will benefit from new foreign direct investment inflows, but their volume is conditional upon the economic growth prospects in Romania and in the main countries of origin. To this add stimulative influences from further assuming an improved absorption of EU structural and investment funds.

87 The coordinates of the Fiscal Strategy for 2019-2021 (March 2019) are aimed at increasing public investment expenditures as a share of GDP by approximately 1.3 percentage points in 2019 and at lowering them by 1 percentage point in 2020. In 2018, this indicator saw a 0.5 percentage point improvement.

Exports of goods and services are expected to advance further over the projection interval, their dynamics remaining high throughout the current year (reflecting the notable quarterly advance in Q1, related however to incidental factors[88]) and subsequently being estimated to decelerate. The anticipated developments in this component take into account: (i) the traction of effective external demand over the forecast interval, although assessed at slightly lower values than in 2018, (ii) the decline in price competitiveness due to the increase in unit labour costs, albeit at slower rates, and (iii) a series of dragging structural features of the economy, such as the slow bridging of gaps regarding the sophistication level of production processes (with a direct effect on the structure of value added of the Romanian products targeting external markets) or the poor infrastructure. The annual dynamics of this component are forecasted to exceed the values in the previous *Inflation Report*, mirroring the higher-than-expected developments in 2019 Q1 (amid an incidental boost of activity in the euro area), to which adds the more stimulative impact stemming from the real effective exchange rate throughout the current year.

The growth rate of imports of goods and services is forecasted to remain swift-paced throughout the current year and then to slow down, reflecting the path of domestic demand and the stimulative impact of exports, which is on the decline in 2020. Imports dynamics are assessed to remain above those of exports, but the differential is seen to narrow. Nominal net exports of goods and services are anticipated to make a negative contribution to the balance-of-payments current account balance, which is seen to be smaller in 2020.

In 2019 Q1, the current account deficit held a close to 4.5 percent share of nominal GDP (cumulated data over four quarters), reflecting the increase in the goods and services deficit, only partly offset by the diminishing impact of primary income. The current account deficit is forecasted to widen in 2019 and the scoreboard indicator set by the European Commission (calculated as an average for the past three years[89]) is expected to surpass the 4 percent-of-GDP threshold as early as this year, also given the high values recorded in the last two years. In 2020, the current account deficit-to-GDP ratio is foreseen to post a level similar to that of 2019. Regionally, the Romanian economy stands out due to the widening of the balance-of-payments current account deficit driven by the negative balance of trade (which is worsening in terms of both intra-EU and extra-EU trade[90]). The financing of the current account deficit is anticipated to be only partly covered by stable, non-debt-creating capital flows over the entire projection interval. The key factors influencing the coverage of the deficit by these flows are, on the one hand, the magnitude of external imbalances

88 In 2019 Q1 the euro area activity witnessed swifter growth, which is however expected to lose momentum over the next quarters, amid the sluggish economic activity in manufacturing (in Germany in particular) and the uncertainties related to trade tensions, with adverse effects on external demand.

89 For further details, see the European Commission's website, the Section on "Macroeconomic Imbalance Procedure Scoreboard".

90 For Romania, a significant contribution to the rise in the negative balance on trade in goods in 2017 and 2018 came from mineral fuels (based almost entirely on the relations with non-EU countries), in the context of higher international oil prices. In the first five months of the current year (versus the same year-ago period) a new widening by EUR 1.5 billion was recorded, with high deficits on chemicals and manufactured goods (especially in relation with other EU Member States), as well as on mineral fuels (in relation with non-EU countries). Overall, January through May 2019, the share of intra-EU trade made a prevailing contribution of 59 percent (EUR 0.9 billion) to the increase in the goods deficit, the rest being attributed to non-EU countries.

and the possible adverse effects on direct investment associated with a deceleration of the economic activity of Romania's main trading partners and in Romania. On the other hand, a partly counterbalancing effect stems from the assumed improvement in the absorption of (mostly structural and cohesion) EU funds. The higher current account deficit carries the potential to act towards worsening the macroeconomic equilibria, with a possible impact on capital flows to the local economy, especially since the position and magnitude of Romania's current account balance are markedly different from those recorded by other emerging economies in the region.

Broad monetary conditions

Broad monetary conditions capture the cumulated impact induced on future developments in aggregate demand by the real interest rates applied by credit institutions on leu- and foreign currency-denominated loans and deposits of non-bank clients and by the real effective exchange rate[91] of the leu. The exchange rate exerts its influence via the net export channel, as well as via the effects on wealth and balance sheets of economic agents[92].

The nominal interest rates on new time deposits in lei are estimated to slightly rise in 2019 Q2 and Q3. As for nominal interest rates on new loans, near-term forecasts indicate them staying at relatively similar values in 2019 Q2, followed by a small increase over the next quarter. Economic agents' saving and investment behaviour is however influenced by real interest rates, calculated based on nominal rates deflated by inflation expectations. For 2019 Q2, real interest rates on new loans and new time deposits are assessed to post values similar to those in the previous quarter. Real interest rates will decline during the last two quarters of 2019, amid rising inflation expectations. Subsequently, they will gradually go up over the projection interval, partly reflecting the downward trend of inflation expectations. Mention should be made that GEO No. 19/2019 stipulates changes in the benchmark index used for the indexation of the interest rate on new variable-rate loans to households, as of May 2019. In this context, the short-term forecasts for interest rates on new loans and new time deposits are marked by high uncertainty about the magnitude of the impact exerted by the changes in the reference rate and in the transmission mechanism[93].

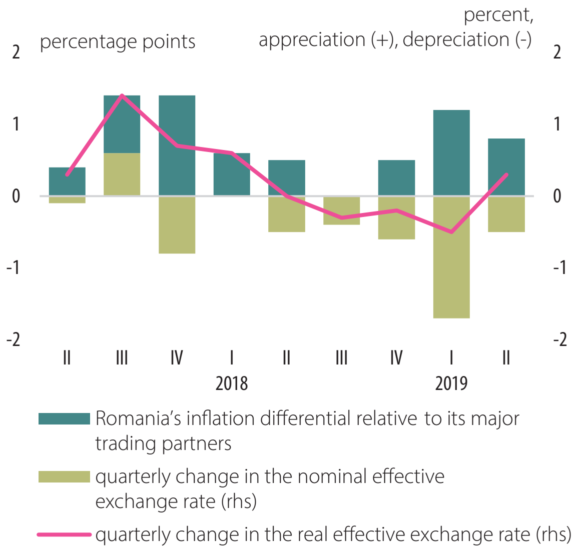
The domestic currency appreciated in real effective terms in 2019 Q2, on account of systematically higher domestic inflation rates as compared to those of Romania's trading partners (Chart 4.9), an impact only partly counterbalanced by the exchange rate developments in nominal terms. For the remainder of the projection interval, the inflation differential will continue to prevail over the nominal exchange rate dynamics and will lead to a strengthening of the domestic currency in real terms. Thus, starting

91 The relevant exchange rate for the NBR's macroeconomic model for analysis and medium-term forecasting relies on the EUR/RON and USD/RON exchange rates, with the weighting system mirroring the weights of the two currencies in Romania's foreign trade.

92 The relevance of this channel has declined gradually in recent periods, given the narrowing of the share of foreign currency-denominated loans in total credit to the private sector, amid the faster rise in leu-denominated flows versus those in foreign currency.

93 The value of the benchmark index for loans to consumers is known for each quarter of the current year. Nonetheless, the influence of these values on the interest rates applied by credit institutions on the new loans and new time deposits of non-bank clients is difficult to assess at present, as the evidence collected subsequent to the entry into force of the new benchmark index (May and June 2019) is minimal.

Chart 4.9. Quarterly change in the effective exchange rate



Source: Eurostat, U.S. Bureau of Labor Statistics, NBR, NBR calculations

2019 Q3, the real effective exchange rate exerts, via the net export channel, a restrictive effect that is gradually rising throughout the entire projection interval.

In 2019 Q2 and Q3 on the whole, the wealth and balance sheet effect is assessed to have stimulative influences on future economic activity, on account of the real foreign interest rate (3M EURIBOR) standing below its long-term equilibrium level (significant negative gap), given the accommodative ECB monetary policy stance, as well as on account of the real effective exchange rate of the leu. Conversely, the sovereign risk premium, approximated based on the option adjusted spread (OAS), is assessed to have a growing restrictive effect, its path being influenced by uncertainties associated with frequent legislative changes and with their effects on the economy's domestic and external equilibria. Over the projection interval, the wealth and balance sheet effect will exert a relatively steady stimulative influence on future economic activity, chiefly on account of the impact of the real foreign interest rate, but also due to the diminishing effect of the real effective exchange rate gap.

Overall, as of 2019 Q2, real broad monetary conditions are assessed to gradually reduce their stimulative impact on future economic activity down to almost neutral values at mid-2020, staying at those levels for the remainder of the projection interval. The key determinant of the path of real broad monetary conditions is the real effective exchange rate, which will exert, starting 2019 H2, an increasing restrictive effect on the price competitiveness of local products.

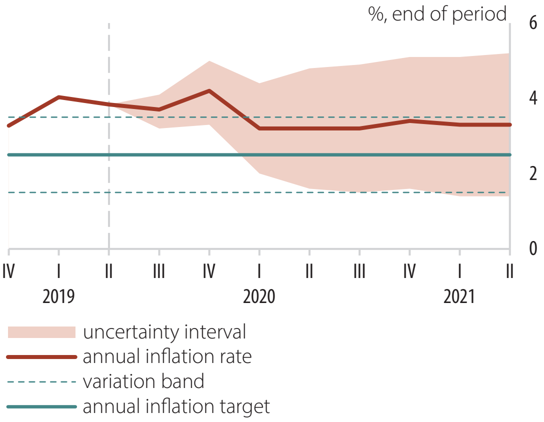
The monetary policy stance is tailored to ensure and maintain price stability over the medium term in a manner conducive to achieving sustainable economic growth and safeguarding a stable macroeconomic framework.

1.4. Risks associated with the projection

The balance of risks to the annual inflation rate projection is assessed as being tilted to the upside compared to the path in the baseline scenario (Chart 4.10), primarily on account of domestic factors. At the current juncture, the fiscal and budgetary measures implemented in 2019 continue to be relevant, alongside labour market conditions. By contrast, pressures with a net disinflationary impact could stem from the external environment, being associated with the slowing trend of economic growth in the euro area and globally.

Similarly to previous forecasting rounds, the fiscal and income policy stance continues to be relevant as a source of uncertainty. On the one hand, the fiscal and budgetary

Chart 4.10. Uncertainty interval associated with inflation projection in the baseline scenario



Note: The uncertainty interval was calculated based on the annual CPI inflation forecast errors in the NBR projections during 2005-2018. The magnitude of forecast errors is positively correlated with the time horizon they refer to.

Source: NIS, NBR calculations and projections

measures implemented in 2019[94] induce mostly upside risks to the near-term inflation outlook, with an impact on inflation expectations. At the same time, the provisions of GEO No. 114/2018, as supplemented by GEO No. 19/2019, are likely to render unpredictable the investment behaviour of economic agents in the private sector. On the other hand, heightened uncertainties arise from the future fiscal and income policy stance, inter alia, ahead of the busy electoral calendar for 2019-2020 and, implicitly, given the regulations to be enforced, as well as the possible compensation measures that would be required to ensure compliance of the fiscal deficit with the envisaged targets[95].

The trade deficit in the first five months of 2019 saw a faster rise than in the same period of the previous year, triggering also a deepening of the current account deficit. Alongside the structural causes, which became chronic over time, the expansionary fiscal measures carry the potential to contribute to the further worsening of the current account balance, by fuelling imports to cover excess demand. Under the circumstances, additional inflationary pressures could also arise from the deterioration of country's external position, with an impact on the exchange rate and, implicitly, on the projected inflation rate path.

Overall, it is essential to put in place a balanced macroeconomic policy mix and to attach greater importance to structural reforms designed to boost the economy's long-term growth potential. These are pivotal to preserving macroeconomic stability and enhancing the domestic economy's resilience to potential adverse developments, in an increasingly fragile external environment.

Another risk factor that proves to be further relevant refers to labour market conditions, owing to the degree of tightness remaining high. The persistence of difficulties in staff recruitment amid skill mismatch puts pressure on wage costs. Similar influences are also associated with other existing structural problems (low internal mobility, the magnitude of emigration).

Looking at the prices of the components beyond the scope of monetary policy, the possible deviations of their coordinates from those in the baseline scenario of the projection remain further relevant. In the electricity and natural gas sector, uncertainties continue to surround end-user prices[96], as their evolution depends on the future decisions of relevant authorities. At the same time, relative to tobacco product prices, additional inflationary pressures may occur apart from those

94 Among them are the fees payable by the holders of licences operating in the electricity and natural gas sectors, the hike in the minimum wage.

95 For 2019 as a whole, according to the Fiscal Strategy for 2019-2021, the deficit target envisaged by the Ministry of Public Finance is 2.76 percent of GDP. In 2019 H1, the budget deficit is assessed at 1.94 percent of GDP.

96 Uncertainties related to developments in the components of the final price (such as distribution tariffs).

generated by the excise duty hikes already provided for by law. As concerns the prices of volatile food items, inherent uncertainty sources refer to weather conditions, with an impact on the supply of agricultural products, both locally and regionally.

On the external front, the balance of risks is tilted to the downside from the path in the baseline scenario. The slowing trend of the euro area and global economic growth could become more pronounced following a possible escalation of trade rows, causing, inter alia, disruptions in global distribution networks and implicitly a decline in the international trade. Furthermore, the potential introduction by the US of customs tariffs on cars and motor parts would affect global economic growth in general and EU economic growth in particular. Brexit-related uncertainties persist alongside the high probability of a no-deal exit. The materialisation of some of these risks could have unfavourable effects on Romania's economy, which would pass through primarily via indirect channels (via trading partners' external demand). Opposite effects are, however, associated with the prospective easing of the monetary policy stance by the ECB and the Fed and with the conduct of central banks in the region.

The balance of risks posed by international commodity prices is assessed to be in equilibrium. Future developments in energy prices remain relevant, especially oil prices, as they are marked by high uncertainties. On the one hand, additional inflationary pressures may arise in the context of increasing geopolitical risks in the Middle East (the civil war in Libya, a potential sequel of attacks on pumping stations and oil tankers, the escalation of tensions in the Hormuz Strait). On the other hand, opposite influences are associated with the outlook for global economic growth to decelerate and US oil stocks to expand amid, inter alia, shrinking demand.

Abbreviations

CCR	Central Credit Register
CPI	consumer price index
DG ECFIN	Directorate General for Economic and Financial Affairs
EC	European Commission
ECB	European Central Bank
ESI	Economic Sentiment Indicator
EU	European Union
Eurostat	Statistical Office of the European Union
FAO	Food and Agricultural Organization of the United Nations
GDP	gross domestic product
GFCF	gross fixed capital formation
HICP	harmonised index of consumer prices
ILO	International Labour Office
IMF	International Monetary Fund
MPF	Ministry of Public Finance
NBR	National Bank of Romania
NIS	National Institute of Statistics
OPEC	Organisation of the Petroleum Exporting Countries
ROBOR	Romanian Interbank Offer Rate
TFP	total factor productivity
VAT	value added tax
VFE	vegetables, fruit, eggs

Tables

Charts